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OVERSIGHT HEARING WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION AND TRADING PRACTICES IN THE COMMODITY FUTURES MARKETS

SEPTEMBER 8, 1989

PART II

Printed for the use of the
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OVERSIGHT HEARING WITH REGARD TO THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Trading Practices in the Commodity Futures Markets

FRIDAY, SEPTEMBER 8, 1989

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Harkin, Conrad, Daschle, Kerrey, Lugar, Cochran, Bond and Gorton.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. Good morning. We have a number of Senators on their way. One of the problems with the Senate's being in session until after 11 last night is that it has thrown a few Senators' schedules out of whack. I know that Senator Lugar is just completing another matter elsewhere and is on his way. Senator Gorton, of course, is here with us.

This morning we continue our oversight hearings on trading practices in the commodity futures markets.

The recent indictments of 45 Chicago futures traders for defrauding customers, along with the emergency and possible manipulation in the July soybean contract, add special urgency to our deliberations today. These scandals lend credence to many of the public's worst fears and suspicions about insider abuse on the commodity futures exchanges. The public's faith in the basic honesty and fairness of these markets has been badly shaken.

We cannot allow financial institutions vital to the well-being of millions of consumers, farmers, and major commercial sectors to be crippled by the self-serving crimes of a few. If the laws have been broken, violators must be punished. If the laws are too weak, then it would be up to us to make sure they are strengthened.

This morning, we will hear reports on two key parts of this picture. First, the General Accounting Office will present its study of futures trading practices mandated by this committee last March. Then, the Commodity Futures Trading Commission will discuss its examination of the July emergency in the Chicago Board of Trade soybean futures contract.

As we begin work this fall on CFTC reauthorization—which I will discuss more during the morning—we must act to restore confidence in the markets based on real reform.

These markets are important to the United States and to world trade. They work only if there is confidence. I think right now that confidence will be maintained only if people know that we are toughening, tightening, and applying the laws. I expect the testimony we receive this morning will give the committee a good starting point in this process.

Before we go to Mr. Fogel, Senator Gorton, did you have anything you wanted to add?

Senator GORTON. No. I would be perfectly happy to hear the witnesses, Mr. Chairman.

The CHAIRMAN. OK, thank you.

Then, Mr. Fogel, it is all yours.

We will insert at this point in the hearing record, without objection, the prepared statements of Senators Harkin and Bond.

[The prepared statements of Senators Harkin and Bond follow:]

PREPARED STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA

Thank you Mr. Chairman. This year will surely go down as one of the most significant and most critical in the history of this Nation's futures markets.

In January we learned of the FBI's undercover investigation of floor trading practices on the Chicago exchanges which led to indictments in August of 46 brokers from four pits at those exchanges.

In May the records of 59 New York futures exchange members were subpoenaed.

On July 11 the CFTC and the Chicago Board of Trade took emergency action requiring liquidation of large positions in the July soybean contract. The July contract dropped 39½ cents a bushel the next day, and cash soybean prices dropped well over $1 a bushel in Iowa following the action. Many farmers believe the soybean emergency action ruined their soybean market, costing them millions of dollars through lower prices.

The central issue is this: How well have the CFTC and the exchanges fulfilled their responsibility to protect customers, farmers and the public and to ensure the orderly and fair functioning of the futures markets?

Based on the FBI investigation, the indictments and the work of the General Accounting Office, it is evident that customers and the public have not had the protection they deserve against various types of unfair trading practices at the futures exchanges.

Now additional questions have arisen from the emergency action by the CFTC and Board of Trade concerning the July soybean contract: Was there really an emergency? What were the alternatives to requiring such a large liquidation of soybean futures positions? Were there conflicts of interest among those involved in deciding to take the emergency action? Was there trading on the basis of advance "inside" information about the emergency action? Who held what positions in the market on July 11 and who won and who lost as a result of the emergency order, and by how much? Why not have delivery of the soybeans instead of liquidating the futures positions? What was the CFTC doing during the time the situation was developing, and should the CFTC have acted sooner to avoid taking the emergency action?

The events of this year have severely tested the principle of self-regulation by the futures exchanges. As they should, the exchanges have the chief responsibility for establishing and enforcing rules to ensure fair and honest trading and to avoid market disruptions. However, the ultimate responsibility for regulating the exchanges and protecting the interests of customers, farmers and the public lies with the CFTC.

This Committee, having legislative and oversight jurisdiction over the CFTC, has a heavy responsibility to address the issues raised by the troubling events of this year. I am confident that we will craft strong legislation responding to these events.

While I certainly do not favor extensive new laws simply for the sake of regulation, it is imperative that there be real and substantial progress in dealing with the problems at the exchanges. We must carefully reassess the balance between self-regulation and the necessity for substantial reform.

I look forward to learning more at today's hearing about the facts of these events at the futures exchanges and about the actions that may be taken to solve the problems they present.

PREPARED STATEMENT OF HON. CHRISTOPHER S. "KIT" BOND, A U.S. SENATOR FROM MISSOURI

Mr. Chairman, I am pleased that we have returned to this issue in such an expeditious manner—I could'nt wait to return from the recess to take up this simple, noncontroversial reauthorization.

Over the August recess, I had a chance to talk with many Missourians about futures markets in general and the situation in Chicago in particular. As you can imagine, there was a good bit of anger and confusion. However, there were several who simply said, "I told you so."

There are now several different issues which have now been rolled into the CFTC reauthorization. However, I caution against spending too much time dwelling on the symptoms—we must go beyond this and focus on the underlying problems. Does self-regulation work? If so, should additional power be granted to the CFTC? In other words, what can be done to minimize the abuse associated with the lure of east money? In my opinion we must review the system of penalties.

Mr. Chairman, talking about stiff penalties is one thing, having the courage to carry them out is another. We must ensure that stiff penalties are the norm, not the exception. If the exchanges won't do it, let's make sure the CFTC does.

This scandal has given entirely new meaning to the word speculator. Some people now believe anyone who trades futures is a speculator—even those who use the markets to hedge their risk. I think this is very unfortunate.

Now is not the time to place blame—not on the markets, not on the Commission. Now is the time to search for ways to prevent this from happening again in the future. The integrity of the markets is at stake.

Mr. Chairman, I commend you for scheduling this hearing so promptly and look forward to working with you, the distinguished ranking minority member and the rest of the committee in efforts to restore the credibility of these important institutions.

STATEMENT OF RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, DIVISION OF GENERAL GOVERNMENT, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC; ACCOMPANIED BY CECILE TROP, ASSISTANT DIRECTOR, GENERAL GOVERNMENT DIVISION; AND RICHARD HILLMAN, ASSISTANT DIRECTOR, INFORMATION MANAGEMENT AND TECHNOLOGY DIVISION

Mr. FOGEL. Thank you, Mr. Chairman.

I'd like to introduce my two associates today. Cecile Trop and Rick Hillman who are assistant directors in the GAO, and they have been intimately involved in doing the work, looking at the trade practices of the futures markets.

We are pleased to be here today to discuss our views on how the Commodity Futures Trading Commission [CFTC] and the exchanges it regulates can better deter, detect, and punish floor trade practice abusers in the futures markets.

If it is OK with the committee, I would like to submit my complete statement for the record, and summarize it at this time.

The CHAIRMAN. I cannot tell you with what enthusiasm the committee would accept that.

Mr. FOGEL. As you know, the results of our work are contained in two reports that we issued yesterday. To do the work, we visited four exchanges: The Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Mercantile Exchange, and the Commodity Exchange, Incorporated.

As you said, recent allegations about trading activities have raised important questions about the integrity of these markets and the quality of Federal and self-regulatory oversight.

INDEPENDENTLY, PRECISELY, AND COMPLETELY TIMING TRADES

Our work also has shown, as indeed did the indictments, that dishonest floor participants, working alone or with a third party, can eliminate the risk of unfavorable market movements. They can manipulate the information on their trading records to give noncompetitive trades the false appearance of having been competitively executed at an earlier time when prices were more favorable to them. These practices could be deterred or more easily detected through independent, precise, and complete timing of trades.

CRITICAL PART OF TESTIMONY

This is the critical part of our testimony. We do not believe that the systems now in place at any of the exchanges can adequately aid the regulators in detecting abuses.

Independent timing could prevent floor participants from using their knowledge of the market price in the immediate past to alter trading records and conceal execution of trades at noncompetitive prices. Precise timing could be used to determine the exact sequencing of each floor participant's trades, thereby making it easier to detect abuses. Complete timing, including the times the floor participants receives and executes the trade, could help reconstruct the history of each trade, not only to detect potential abuses, but also to prove that they occurred.

Now, as I said, the exchange trading systems generally don't do these things. What the exchange systems attempt to do is reconstruct the sequence of trades using times that may be based on inaccurate or incomplete information. The timing information used to reconstruct the sequence of trades is part of the "audit trail," which is the documentation for all trades.

AUDIT TRAIL INFORMATION

While the audit trail information is obtained somewhat differently at each exchange, and different weaknesses exist in the audit trails of each exchange. However, the audit trail systems of three of the four exchanges we visited include some timing information provided by floor participants, such as trade time and sequence information. These systems, therefore, depend on the participants to submit accurate and complete timing information. The fourth of the exchange's system records times independently. But like the other systems, it does not record times precisely or completely. Therefore, it has difficulty sequencing trades, especially in active markets. Thus, in each system, opportunities exist to manipulate the timing, and, therefore, the sequencing of trades.

As we all know, CFTC has implemented a 1-minute timing standard to try to improve things, and to the extent that audit trail information from floor participants is used to meet the CFTC 1-minute timing standard and reach the reported verification rates, neither the times nor their verification rates may be reliable. Even if the 1-minute times were reliable, they are not precise enough to always allow for complete sequencing of each floor participant's trades because many trades can occur within a 1-minute period. Finally, none of the exchanges precisely times when floor participants receive or execute customer orders. This time could help establish when participants assume responsibility for promptly and competitively executing the orders.

PROPOSED RULE AMENDMENT

CFTC proposed rule amendments in August 1989, tightening controls over the preparation and the submission of trading cards and submission of customer order tickets that will improve timing information and trade sequencing. The rules could go into effect in early 1990, and the exchanges have already begun implementing some of these changes as well as others. While these changes are important interim measures, we believe they still fall short of what needs to be done, because floor participants will still be relied upon to provide accurate trading records, and trade times will not be exact and complete.

EFFECT OF DUAL TRADING ON MARKET INTEGRITY

A lot of attention has been directed to the effect of dual trading on market integrity. Restricting dual trading would not prevent floor brokers from using a third party to indirectly trade ahead of customers. In fact, the Justice Department indictments allege that some brokers were using third parties in an attempt to mask illegal trades. Trading ahead abuses could more easily be detected if trade times were independent, precise, and complete because the exact sequence and price of each floor participant's trades could be readily determined, as could the time when the floor broker received the order. Therefore, restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations.

ASSESSING AUTOMATED SYSTEMS

Although the exchanges' planned automated systems have the potential to better control trading abuses, they introduce new risks that must be addressed to ensure correct transaction processing, responsive operations, and secure and continuous service.

One of the problems, though, is that CFTC has not been actively involved in technical assessments of these systems' capabilities to control trading abuses and automation risks. CFTC needs to provide the necessary expertise to ensure that the systems currently planned by the exchanges maximize their potential to control trade practice abuses. It also needs to assess the risks of using automated systems. To accomplish these goals, CFTC could allocate its own resources, establish a technical advisory committee, and/or require the exchanges to have independent assessments performed on their systems under CFTC guidelines.

IMPROVING AUTOMATED SURVEILLANCE

Trade practice abuses can be detected by various means, such as manual review of the trade register, surveillance of the trading floor, and complaints from members. In addition, at different times over the last 4 years, the exchanges began using automated trade surveillance systems to review all trading activity and to provide investigators with exception reports that highlight suspicious trading activity. However, as we have discussed, the audit trail data upon which these systems rely is too imprecise for these screening programs to accurately identify all potential abuses, and some of the systems are still in the early stages of development.

CFTC needs to do a better job of independently testing screening programs, and to do this, they could run data containing known violations through the exchanges' systems; but again, unless these programs rely on precise, complete, and accurate information on trading times coming from the floor, they are of limited use.

USING MANAGEMENT INFORMATION

CFTC also uses investigatory and disciplinary action information to judge specific exchange decisions and to monitor exchange progress from one rule enforcement review to another. But it cannot use this information to formally analyze trends and compare results among these exchanges, because no uniform definitions exist for classifying the investigations and disciplinary actions involving floor trade practice abuses.

CFTC and the exchanges are beginning to develop uniform definitions. Our recommendations are designed to ensure their rapid completion and to encourage CFTC to better use the resulting improved disciplinary and investigatory information in its oversight.

ASSESSING DISCIPLINARY ACTION PROGRAMS

You also asked us to look at the disciplinary action programs of the exchanges. The number and severity of disciplinary actions that the exchanges have taken varies by exchange, but has generally increased as shown in the attached charts to our prepared testimony.

However, we were unable to evaluate the significance of the differences in exchange disciplinary actions because the universe of abuses is unknown and the uniqueness and complexity of each case preclude an assessment of the adequacy and consistency of penalties. Moreover, the results of our comparisons of futures and securities market disciplinary actions were not useful because of differences in the types of abuses that occur in the two markets.

CFTC and exchange officials said that they are concerned about perceptions of potential conflicts of interest and about the fairness and consistency of the disciplinary action process. As a result, CFTC has issued proposed rules governing the eligibility of members with prior disciplinary histories to serve on disciplinary committees. Also, the exchanges are considering actions, and in some cases have taken actions, that they believe will improve perceptions about the fairness and consistency of disciplinary action programs.

SUMMARY AND CONCLUSIONS

In summary, there is no doubt that CFTC and the exchanges have been working, and were working before the FBI investigations, to improve the framework of controls over floor trade practice abuses. They certainly intensified their efforts after news of the investigations became public, and have proposed or taken a series of actions, such as requiring more frequent collection of trading cards, that will improve existing exchange internal controls.

These actions are important interim measures for reducing the opportunity for dishonest floor participants to commit trading violation. However, CFTC and the exchanges must do more. While detecting every abuse will never be possible, CFTC and the exchanges need to take actions that will upgrade the overall character of market oversight and substantially reduce the opportunity to manipulate trading.

Foremost among these actions needed is improved timing of all trades. Most of the types of abuses alleged in the Justice Department indictments could have been more readily detected and documented with independent, precise, and complete timing of trades.

That does not mean if a group wants to get together and really collude to beat any system, they could not do that. Collusion can thwart any system. But the key point is, if you have more precise, independent and complete timing of these trades—which means the exchanges must go to automation in the pits—you could greatly reduce the extent to which the potential for abuse could occur.

For this reason, we are recommending that CFTC require the exchanges to go beyond upgrading existing internal controls and implement systems to independently, precisely, and completely time all trades.

We are also recommending that CFTC enhance its capability to evaluate the risks and technical configuration of emerging automated systems, expand its review of exchange automated surveillance systems, and improve its use of management information.

I would like to make one final point. It has been known for some time that the potential for trading abuses on the future exchanges is high. CFTC's recent proposals to better control trading abuses are, as I indicated, earlier, useful interim measures. But, they do not go far enough. We believe it is essential that CFTC become more proactive in overseeing trading practices.

The alleged abuses in the Department of Justice indictments and the growing importance of the futures markets in our economy make it essential that the operating standards of market participants be upgraded. CFTC needs to lead the effort to accomplish the needed improvements.

We would be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

I have a number of questions. As I mentioned at the beginning of this hearing, Senator Lugar was detained in another matter. I want to yield first to him for a statement and then we will begin a round of questions.

I want to say, Mr. Fogel, that I appreciate the report. I read it through last night with a great deal of interest and I rather suspect that among those represented by some of the people in this room, it is also being read with a great deal of interest throughout Washington and Chicago.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator **Lugar**. Thank you very much, Mr. Chairman. I appreciate your allowing me to make this short opening statement.

In my judgment, Mr. Chairman, this hearing is important to the future of this industry. It will help us resolve some of the important issues before this committee and I look forward to the testimony of both witnesses.

It is my opinion that the public confidence in the futures markets and the CFTC is at a low level. Commodity markets will find it increasingly difficult to operate efficiently in this environment. This is particularly troublesome to me when these markets are the cornerstone of our commercial marketing system.

Over the years we have fought a number of jurisdictional battles over which agency should regulate these markets. And in the past it has been a battle in which I have fought vigorously, with the chairman, in defense of the Commodity Futures Trading Commission. However, we cannot support a situation in which the users of these markets question its integrity. Markets are severely weakened when a substantial percentage of the traders in a particular pit are under Federal indictment. If it comes to protecting the viability of this important center of commerce, questions of jurisdiction become considerably less important than the integrity and viability at futures markets.

This committee is charged with the responsibility of overseeing a regulatory process that is badly in need of repair. As I see it, the futures industry has one more chance to reestablish its credibility and restore market confidence. I share the concern of the chairman, and pledge my efforts to work to fashion legislation that will enhance the ability of the CFTC to perform those very important tasks.

Many unanswered questions remain about the trading abuses that led to the Chicago investigations and indictments and most recently the actions surrounding the July soybean contract. Therefore, I welcome, along with the committee, the input and information provided in that regard from the testimony of the witnesses today.

Mr. Chairman, I will have more questions in regular order, but I share your compliments to the first witness on a very comprehensive and important document.

The **Chairman**. Thank you very much, Senator Lugar. I know the concern that you have on this. You and I have sat here at this table for a dozen years watching some of these issues.

I wonder, Mr. Fogel, if you or your colleagues would like to answer this basic question: Is it your view that current audit trails systems in place at the major U.S. futures exchanges are fundamentally inadequate to police the trading floors against abuses?

Mr. **Fogel**. I think they are, yes, and I think we reached that conclusion after intensive study over the last several months, and what led us to that conclusion is the fact that the audit systems, to be effective, have to rely on accurate information coming to them.

And what the customer has to be really concerned about in the market is when his or her order gets to the exchange booth, and generally that is known now. The second critical time, though, for any customer, is when the order gets to the broker—and that isn't known right now, in terms of exact timing.

The next critical time is when the order is executed by the broker. That isn't known right now, either.

What the audit trail system does is—and I have asked the staff—we have some cards here that people in Chicago certainly know about. They take these cards. They put them in the computer system, and then they impute the time that the order was executed by looking at the price and the brackets and everything, but there is no exact time that comes in that says when the order was executed. And the fourth key time is when the order gets to the booth from the pit.

And because the audit systems now have to rely on imprecise times, which we just think are fundamentally flawed, a basic change needs to take place in how the transactions are monitored and timed in the futures markets.

The CHAIRMAN. Considering all the money, all the time, all the expense, all the effort, all the expertise, and all the hours in this committee and of everyone else that have gone into creating the current audit trail systems your answer is not very comforting.

I happen to believe that your answer is correct, but I am sure you understand there will not be a lot of people taking a great deal of comfort in it, considering what has been done in that regard.

If we adopt your principal proposal—that exchanges implement new audit trails that are able to record the times of trades, as you say, "independently, precisely, and completely"—if we do that, would there be any need to eliminate the current open outcry trading system?

Mr. FOGEL. Let me go back first to the point you made on the audit systems. We need the audit trail systems, so I do not think that the money that has been spent or the time and effort that was spent in developing those was wasted.

What we need is a better system to get more accurate information into the audit trail system.

The CHAIRMAN. But if we do that, can we still maintain the open outcry system?

Mr. FOGEL. I think that is a question that the exchanges themselves need to answer. I don't personally believe that the Government should dictate how the exchanges want to trade, whether they want open outcry or screens or anything like that.

I think the regulators and——

The CHAIRMAN. But if they wish to keep the open outcry system, is it possible to do that and still have the kind of independent and complete audit trail systems that you are proposing?

Mr. FOGEL. Well, I think the exchanges——

The CHAIRMAN. I am thinking, for example, about the plan recently announced by the Chicago Board of Trade and the Chicago Mercantile Exchange to work toward developing hand-held trading devices and automated order-routing systems.

Mr. **Fogel**. Well, I think that was what I was going to say, that the exchanges think it is certainly possible to do that, if you could develop a small hand-held computerized device that would enable the traders in the pits to record the information so it could be electronically transmitted.

So I don't think that getting precise, independent and complete timing is a threat to the open outcry system.

The **Chairman**. From GAO's point of view, as systems like this are being developed, I assume that it would be possible for you to determine whether they are keeping the kind of up-to-date, independent, complete, and precise data that you suggest.

Mr. **Fogel**. Yes, we could. I would like to let Mr. Hillman explain in a little more detail how we do that, because it gets into a key point of when you begin to computerize operations, what expectations of capacity do we have to have for the regulators, and indeed for us at the GAO, to be able to go in and effectively determine whether these systems need to work.

And one of our concerns, quite frankly, in the past, and it has not only been a concern at the CFTC, it has been as much of a concern we have had with the SEC, too, is that the regulators haven't had enough of an appreciation or understanding of what they are going to need to do with these computerized systems to validate their accuracy and to check on things.

The **Chairman**. Mr. Hillman.

Mr. **Hillman**. In discussions with the Commodity Futures Trading Commission, they told us that in their view the exchanges had a vested interest in developing sound systems.

We believe and agree with the Commission that the exchanges do have a vested interest, but also believe that the Commission has an interest in ensuring that those systems are sound as well.

In our view, the Commission has not played a proactive enough role in reviewing exchange systems. Such a role would include assessing the extent to which the exchanges are maximizing the use of technology to ensure that they are able to better detect or deter trade practice abuses, and mitigate the risks associated with introducing automation into the open outcry process.

The **Chairman**. What would it cost to do it right? $10 million, $20 million, $30 million? Do you have any idea?

Mr. **Hillman**. No, I do not, Mr. Chairman. Current plans call for the exchanges to spend $5 million to conduct research on developing an alternative that can be used to augment the open outcry process. Depending upon the alternative selected, the cost could vary.

The **Chairman**. But you do not have an idea of what that cost might be, Mr. Hillman?

Mr. **Hillman**. No, not at this time.

Mr. **Fogel**. I think it is obviously going to cost some money, but I think the question has to be asked, and the markets have to answer this themselves, what price are they willing to pay to achieve better integrity in their markets?

They are moving toward computerization anyways. I think one of the questions the markets have to ask themselves is, what is the marginal cost going to be to get this better timing?

The CHAIRMAN. How precise must the timing be for the system to work? Must it be to the nearest 5 seconds, 10 seconds, 15 seconds, 20 seconds? No matter what system you use to make the trade, it will physically take a certain amount of time to punch the data in, whether it is done through a hand-held device or some other system.

Is there a magic number for measuring precision, or does this come more from the way the system tracks trades?

Mr. FOGEL. Well, I don't know that there is a magic number. Our discussions with the Chicago Board Options Exchange officials who tested some hand-held devices earlier indicated they had some valid concerns.

I think that Rick can check me on this, that they estimated that on the average, using the cards in a busy time, a trader could make a trade every 3 seconds, and with the hand-held device that they were testing at that time, the traders could only make trades, what, about every 7 seconds?

Mr. HILLMAN. Yes.

Mr. FOGEL. About every 7 seconds. So the traders had a very valid concern that if they went to the device they were testing at that time, the rapidity with which price discovery could take place and transactions could take place will be reduced, and that might have an adverse effect on the character of the pits.

Now, that was an earlier test, and I don't think we want to downplay the technological advances that are going to have to take place to do this, but there may be other ways to do it, and that is why we are encouraged that both the Board of Trade and the Merc are willing to invest up to $5 million.

We do not know what the exact number is, but what we think is key is that somehow the trader has to record—like on a slate or something—the information that is then transmitted independently somewhere else.

The CHAIRMAN. I think all of us agree that there will have to be a new system for audit trails.

Now, we are also going to have to do this within a realistic amount of time. That deadline can be set by the CFTC or it could be set by the Congress. I realize that we are trying new technologies and not something off the shelf. When you try any kind of new technology, there are always some things that go wrong. You need some debugging.

But I am convinced that we are going to set a time limit. Do you think if we set 3 years as the deadline that this would be long enough to work out the bugs and get the new systems going?

Mr. HILLMAN. Depending upon the results of the research, and to the extent there are no real significant technological flaws in developing such a system, the exchanges tell us that they ought to be able to complete the research, test devices, within a year.

They also tell us that they ought to be able to train the members to use devices and reconfigure the pit processes within another year.

So in our view, a 3-year limit does seem reasonable.

Mr. FOGEL. I think our feeling, too, is that we would strongly support trying to put some timeframe in the statute. That is a very healthy target for the regulator and the exchanges to then try to meet——

The CHAIRMAN. Mr. Fogel, I think there is going to be a time limit in the statute, let me tell you right now.

Dick.

Senator LUGAR. Mr. Chairman, let me just follow through on some of your questioning.

In your report, Mr. Fogel, you said on page 7 that CFTC has not been actively involved in technical assessments of these systems' capabilities to control trading abuses and automation risks, and you suggest CFTC needs to provide the necessary expertise to ensure the system currently planned by the exchanges maximizes potential control trade practice abuses.

Obviously, that is right, CFTC has not been involved to the extent they should have been, and they need to be. From your observation, as of this moment, are they?

We have been talking this morning about several substantial innovative changes, the hand-held computer for one. Is CFTC monitoring that computer trying to accurately gauge the extent to which it meets the regulatory needs now under the statute, or the ones that are perceived by CFTC as it is investigated?

Mr. FOGEL. Well, I think we noticed a very positive change of attitude, or perhaps a better way to describe it is a better understanding among the CFTC staff of the need to become more actively involved.

And in our discussions with the Commission at a close-out, one of the things that we recommended is that they seek more resources or put more resources into this computerized area, and we were advised by Ms. Gramm that they intend to do that.

So I would like to let Rick get into some details, if he wants, but generally, they are making progress trying to get up to speed. I do not think they are where we would like them to be today, but I think they have recognized the need to do it, they said they are going to commit some resources to do it.

So they are on the right track.

Senator LUGAR. Well, you have commented in response to Senator Leahy that you don't believe the Congress should mandate any particular trading method. This was in response to a question of ending open outcry, as opposed to Globex or Aurora or one of the comprehensive automated systems, and philosophically I would tend to agree with you.

It just seems to me that we are in a situation here in which a number of us have begun to lose confidence in the system now in place. We have lost confidence in the ability of those involved in the trades to reform their own practices, and have some concerns about the ability of CFTC to get on top of this and reform it.

As you point out, they are coming up to speed, but we are confronted with a situation in which there is a considerable amount of concern. I realize that we went through a similar line of questioning when GAO last reported to the committee, but what are the significant reasons why the open outcry system is not terminated immediately, and we shift immediately to automation?

In other words, it appears to me that even with a hand-held computer, and this analogy may not be perfectly accurate, the markets are like an athlete in a game trying to time his performance as opposed to the referee, the timekeeper, or now even in NFL football, instant replays accurately recording the performance.

Mr. FOGEL. You think we are going to have that at the CFTC?

Senator LUGAR. Well, our society has dictated that it is worthwhile enough, with regard to the accuracy of referees' calls in football, to spend millions of dollars on the technology that is required to see every play and to play it back and forth from many angles.

In this case we have a situation where billions of dollars and the integrity of a market are involved, and there is considerable temptation to cheat. I see from the the standpoint of both the regulators, as well as those who are in the game, to question the accuracy of the calls and the degree of the comprehensive scrutiny that is involved.

Why the reticence? Is there something technologically inferior about going to a comprehensive automated system, as opposed to the open outcry system?

The only argument I have heard, and there may be others, and I have asked this question now openly for the last 6 months, waiting for the other arguments to come, the argument always is that volume seems to dictate the need for open outcry. The argument is that somehow or other technologically a computer system cannot encompass the volume, although others have refuted this out of hand, and reported that the rest of the world is trading this way.

We have the anachronism of open outcry simply because it is the way we have traded in the United States for years while the rest of the world contends with the markets for 19 hours some other way.

Can you illuminate this basic question without regard of who is to solve it, either the markets or the Federal Government or this committee?

Mr. FOGEL. Well, I don't want to be characterized as saying that the GAO is a defender of the open outcry system, and I think the best people—as I am sure you already have—to get to defend that would be the people running the exchanges.

There is no doubt. I mean, if you look to the future, that computerization and screen trading is probably the wave of the future. I think that is one of the reasons in the off-hours the exchanges are trying to develop things such as Globex and Aurora.

I think if they test those in off-hours and they see how that goes, the probability would be that they may want to go to more computerization in on-hours.

On the other hand, though, I do not think that the Congress or the regulator should shy away from forcing more computerization, for example, like we think has to be done to get more precise timing on the markets, and then let the markets figure out how to do that.

And if they decide that to meet the regulatory standards that the Congress thinks are necessary to ensure the integrity of the systems, they have to change the system, so be it.

Senator LUGAR. But what if we said that the requirement would be accuracy to the second? Doesn't that denote that you really must have a computer, that you have an indelible electronic impulse in which you plug in, to buy, say, 100,000 bushels of beans, and the electronic impulse records the trade and that is that?

Mr. FOGEL. I would tend to think it would be, yes, that it would imply that you would need to go to a computer.

Senator LUGAR. So, by drafting guidelines we could fairly well dictate the technology that is required to meet that?

Mr. FOGEL. Right, and that could be the case, yes, and I think that is why it is important to engage the CFTC and the markets in discussions.

We use the word "precise," and if we had the ideal world, precise would be to the second, and I think there has to be some discussion of how precise we can get, how quickly.

Senator LUGAR. Now the reason I pursue this is that in the past this committee was haggled over how many minutes or segments would maintain market integrity. As surely as this committee begins to narrow the timeframe down, believing that somehow or other we are going to wring some integrity out of the market through these efforts, there always appear to be people in this world who know how to take advantage of that small interval to create mischief.

Therefore I am logically forced to suggest that there can't be any intervals. There can't be any chance for mischief. We really have to have the technology and systems to eliminate that opportunity.

Now, in the event the industry simply wants to maintain the latitude for skulduggery the issue turns on the pace for reform and purpose. If some of us are becoming impatient with the industry as well as the CFTC, it ultimately comes down to the leisurely pace with which reform is occurring.

While at the same time, the industry makes the very good point that if we don't maintain this industry, some other country will take it from us. This means a loss of jobs and a loss of national prestige.

Now, the issue is, to what extent should this situation be left in the hands of the people who are mismanaging it. That is why, it seems to me, that we really have to force the technology issue. I do not think that the arguments have been refuted, recognizing that there are inconveniences, and there are expenses.

We are talking about hundreds of billions of dollars of domestic industry that could be substantially lost if this problem is not cured.

So I appreciate your pinpointing this. I suppose we are looking for some support and technical information as to what approach might be feasible, or reasonable.

Mr. FOGEL. Right. Well, we would certainly be glad to continue to work with the committee in trying to provide, through our computer experts at GAO, some continuing assessment of how things are working.

I would like to make one request, that is, as we work with you on this, we would like to work with the committee in drafting the legislation to assure that GAO has sufficient access to the information in the automated systems on the exchanges so that we can independently really assess how well the regulator is doing its job.

And working with our lawyers, we are looking now at the extent to which we may need to clarify that access a little bit, to make sure we can do that.

Senator **Lugar**. Mr. Chairman, I think that would be a good suggestion, because we are calling upon GAO with some frequency on how to evaluate the auditors.

The **Chairman**. We are going to give them a separate office up here, just to make it easier.

Senator **Lugar**. I want to make certain they have a good insight into what is occurring.

The **Chairman**. I agree with you.

Senator **Lugar**. I thank you very much.

The **Chairman**. I think the frustrations that Senator Lugar has suggested are frustrations that we are hearing more and more up here. I mention that just for those who are concerned about this, whether in the industry or elsewhere. I hope they have listened very carefully to what the distinguished Senator from Indiana has said.

Senator Gorton, we will go over to you, and then Senator Conrad, and then Senator Kerrey.

Senator **Gorton**. One question. Until such time as we have a no interval, entirely computerized system, do you think that it is going to be necessary that there be in fact or at least the threat of a constant sting operation going on in these markets in order to assure regularity and honesty?

Mr. **Fogel**. I think that the regulator has to continue to be vigilant, and perhaps be more aggressive than they have in the past.

I want to be a little hesitant in saying whether we think there needs to be the continual threat of a sting operation because we do not know enough about that, although we are not opposed at all to the use of those types of operations to ferret out people who are violating the law.

And there is no doubt the interim measures that the CFTC and the exchanges are taking, and propose to take, are important, but they don't solve the problem. So we think there is going to be continual vigilance here to make sure that those people that want to manipulate or get in schemes with each other couldn't do it. So I am sort of dancing around.

Senator **Gorton**. It is a most diplomatic answer.

Mr. **Fogel**. But, you know, I——

Senator **Gorton**. Yes is certainly not inconsistent with it.

Mr. **Fogel**. I think the best people to really ask that question of probably are the enforcement people in CFTC, who should have a good sense of how the markets are behaving, more closely.

Senator **Gorton**. Well, let me ask that question in a little bit different way. What is your observation as to where we would be right now on this day with respect to needed changes, had it not been for this current sting operation and the indictments which have followed from it?

Mr. **Fogel**. I certainly don't think we would have been as concerned as we are about abuses. I think there's no doubt that the more we looked at the markets we would have probably reached a conclusion at some point in time that precise timing was needed, but I read the indictments, and if everything was always true in all indictments our cases would be very easy.

But I think the thing that struck us, or struck me when I read those indictments, if the allegations are true, is that you had people that were really scheming and colluding and setting up systems and relationships off the floor, and doing things that then when they got to the floor that, if proven correct were really criminal, and they were abusing their customers.

Senator **GORTON**. And obviously they thought they could get away with, given the system in effect at the time.

Mr. **FOGEL**. That's right. Now I want to make the point, no system is foolproof, and there is no way that even if you get all these improved timing things that you are going to catch everything. But what that would do is at least provide better information.

You still have to be able to understand the relationships that exist, and who is trying to talk with whom after hours, and that type of thing. I mean, you know, there were third parties involved in these schemes, and everything else.

So I don't think there is any doubt that the undercover operation brought out, on the surface, allegations that have really increased everyone's awareness concerned of how markets could be manipulated.

Senator **GORTON**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Gorton.

Senator Conrad.

Senator **CONRAD**. Thank you, Mr. Chairman.

I want to thank you for holding this hearing, because I've just come back from 26 cities and towns in my State, and I found real anger about what has occurred here, and a significant erosion of confidence in the markets, and a significant erosion of confidence in the regulatory authority.

The two things that strike me that we must provide, one, a very clear explanation of what occurred, how it occurred, why it occurred, and second, that we be able to assure our people that this will never happen again.

Those two things, it strikes me, are absolute requirements for us.

Now, that leads to the two issues. One is the audit trail, and the question of eliminating the time gaps that allow people to play games. That goes to the whole series of questions that Senator Lugar asked today, and has asked before, and I would extend his question by asking this:

In your investigation, does the open outcry method give us a competitive advantage over other markets? Did you find that? I ascertain from your suggestion that you reduce the time required for each transaction when you have open outcry and you don't have a hand-held computer—that there may be some competitive advantage to that system. Is that the case?

Ms. **TROP**. The open outcry system, I think, is valued because it provides among the smallest spreads between the bid and the ask price on a transaction, which means that you can go to the futures market and hedge your risk more cheaply than almost anywhere else.

You can compare that, for example, to the swap market, where you don't have an organized exchange, and to achieve the same result is much more costly.

So the answer is, yes, there is an advantage to having this market and this way of doing it.

Senator **Conrad**. And is that compared to a fully electronic means of trading? In terms of cost.

Ms. **Trop**. Well, Rick, you might want to talk a little bit about the risks that are involved.

Mr. **Fogel**. Well, compared to the—I don't think it is compared exactly. I spent 3 weeks in Europe earlier this summer talking to regulators in all the EC countries, and market participants in various markets, and one of the senses I got is that participants really look to the market, because of the contract that is being traded.

Obviously they want to do it in the most efficient market that they can, and there is no doubt that in European countries, and the EC countries, that they think the future is in computerization—in screen trading.

Now, they're not there yet, and I think it was somewhat comforting, quite frankly, when I was over there because I got the sense that our markets are much more dynamic, innovative and, in a very positive way, more aggressive than the European markets, and we don't want to lose that.

Senator **Conrad**. Is open outcry important to aggressiveness, innovativeness, and creativity?

Ms. **Trop**. It's hard to tell, because those markets that are computerized right now don't have the volume of our market. You can't directly compare them. We don't know if we completely computerized——

Mr. **Fogel**. I think we may have a better sense of how important it is once, let's say, the Merc and the Board of Trade get their after-hours trading up to speed. I wouldn't want to flat-out say at this time it isn't a factor, but it's difficult for us to judge how much of a factor the open outcry system is.

Senator **Conrad**. One final question, and that relates to dual trading, because as I traveled across my State having community forums, people asked me, how can you guys allow a system whereby somebody trades for their own account, as well as the customer's account? Isn't that an open invitation to skulduggery?

What would be your response to that question?

Mr. **Fogel**. It certainly is an invitation to skulduggery, and the potential for abuse. I think the point we want to make, though, and we've tried to emphasize in both our testimony and our report, is that restrictions on dual trading are no substitute for getting precise, complete and independent timing.

If you want to discuss some limits on dual trading, and I know some of the exchanges have proposed them, and the CFTC has a study under way now—we are certainly not opposed to looking at those things to see whether there ought to be some limits.

But limiting or banning dual trading doesn't really solve the problem. In fact, one of the things that we noticed in some of the indictments is that these people were smarter than to just dual trade for themselves. That is relatively easy to pick up.

What they did was involve third parties, and they weren't——

Senator **Conrad**. The only way to stop that is with the audit trail.

Mr. **Fogel**. That's right. So dual trading has the potential for abuse, but the smart traders, if they want to cheat, probably wouldn't go that way.

The **Chairman**. Thank you, Senator Conrad.

Incidentally, on an entirely different matter, for those who are going to be at the hearing on Monday, the weather report is for cloudy skies, cool temperatures, high 70's, and possible showers. We are trying to do something about the showers.

Senator Kerrey, and then Senator Cochran.

Senator **Conrad**. Send the showers to North Dakota, will you, Mr. Chairman?

The **Chairman**. We have had more than enough showers in Vermont. On my farm we are just doing a second cutting of hay. We normally never do this.

Senator **Conrad**. We will take some of the hay, too.

The **Chairman**. I will pass out bales for all those who arrive in Vermont. [Laughter.]

Senator Kerrey and then Senator Cochran.

Senator **Kerrey**. Mr. Fogel, you may not be able to answer the questions I have. I am trying to determine the effectiveness of the CFTC's current regulatory approach toward the future's industry.

In this particular instance, we have a form of regulation, usually referred to as self-regulation, and my question is whether or not you have done any analysis, or whether you are prepared to comment on whether or not, in fact, we are ever going to be able, under this particular form of regulation, to accomplish the necessary level of oversight?

Mr. **Fogel**. I take it you are alluding to the fact that we have the Federal regulator, and then we have SRO's—self-regulatory organizations, and so forth.

We are comfortable with the structural framework that exists in both the futures and the securities industry, where you have a Federal regulator, and you rely on self-regulatory organizations.

Senator **Kerrey**. Can you tell us, as well, what generates that comfort?

Mr. **Fogel**. Yes, I think that there is an awful lot of detailed activity dealing with sales practices, trading practices and so forth, that historically over time—I guess if you go back—and I have done a little reading on this—back into the thirties when we set up the SEC, there was obviously a move on the part of the securities industry to ward off Federal regulation, and they came up with the self-regulatory structure.

But over time it has evolved so, at least on the securities side, I would say to a greater extent today than on the futures side, quite frankly, that there is a better and more aggressive willingness on the part of some SRO's on the securities side to regulate.

I think that the way we have structured it so that you use resources of the securities industry to do part of the work, and they can then refer things up to the regulator, doesn't seem to work badly, when everyone is consistently trying to achieve the same thing.

The problem we have had is the extent to which sometimes the Federal regulator has wanted to exercise its authority aggressively enough to get the SRO's to do their job.

Senator **Kerrey**. Let me be a bit more general. I have a sense that what I am trying to do is make judgments about an activity that I really don't understand as well as I liked to, to put it mildly.

I have had some experience with futures trading, and I have been following closely what has transpired to produce the indictments and that sort of thing.

Mr. **Fogel**. Right.

Senator **Kerrey**. But nonetheless, my knowledge of what actually goes on on the floor is not as great as I would like. Moreover, my capacity to devote much time to the task of oversight is not great either. And, my confidence in the ability of the exchanges to regulate themselves is not great, particularly when given the collapse of confidence, frankly, that you look at the testimony that the exchanges gave 2 years ago and a year ago, and listening to them get very defensive when I brought up the *Sanders* case this spring, and when I cited the comment by Judge Aspen that there is a cesspool of corruption at certain exchanges.

As I listened to the exchanges' response to all this I found myself losing all confidence in the exchanges. I don't yet have an alternative, but I am trying to determine if you have done a comparative analysis of various regulatory systems.

Mr. **Fogel**. Well, I think the first place you would have to look, if you don't have confidence, it seems to me, is in the philosophy and approach of the Commissioners that we appoint—that the President appoints and that you all confirm—to the regulatory agencies.

I think our experience has shown that the Commissioners can have a great effect on the extent to which the regulator wants to, for example, continue to suggest that actions be taken, as opposed to recommend or require SRO's or exchanges to adopt various measures.

Let me give you an example. We noted in our testimony that there have been discussions over time about the lack of definition of what abuses are, and one of the things that we would like to see are some common definitions, so that the CFTC could do more analysis to see where trends with problems are.

Now, this discussion has been going on for a long time. I don't know how much it would take on the part of CFTC to basically get those exchanges in a room and sit around a table and say, let's just get the thing done.

We have seen some of the same problems, quite frankly, at the SEC on some issues, where they have been discussing with the exchanges for a long time various things, on how brokerage houses would have to report certain things, and they continually engage in discussions, but it takes them sometimes years to reach closure on issues.

Senator **Kerrey**. Do you think that the CFTC's philosophy and attitude have been one of a light regulatory hand on the exchanges?

Mr. **Fogel**. In some cases I think that has been the case, yes. I think that we would like to see them, as we said, be more proactive in some areas.

Senator **Kerrey**. Could you comment just briefly, because I am about at the end of my time on how you would weigh the relative skill of the traders, in one instance, versus the ability of the regulators to stay one step ahead of them?

Mr. **Fogel**. Um-hum.

Senator **Kerrey**. I am referring to the quality of the regulatory mechanism, and how you would weigh the CFTC staff, and the staff of the exchanges, and the individuals that are actually in charge of the regulatory process.

It seems to me, if it were my task alone to examine this situation and try to make some sort of rational judgment, I would do it that way.

I would say, well, maybe we haven't done a good enough job of selecting the people who are responsible.

Mr. **Fogel**. Right.

Senator **Kerrey**. Maybe there is something wrong with our regulatory mechanism. Maybe there is something wrong with the rules and regulations. Maybe there is something wrong with the Commissioners themselves. Maybe there is something wrong with the staff.

I am trying to get some sense of whether or not you have done that kind of comparative evaluation.

Mr. **Fogel**. No, I don't think we have done any detailed comparative evaluation. I think if you start with the quality of the traders, the way the regulatory process works, we rely on the SRO's to basically check out the traders, and what it really takes is a commitment on the part of National Futures Association and the exchanges to want to get honest people in there, first of all, and it takes that same commitment on the part of the staff of the CFTC, and the Commissioners.

And over the years, I think we have seen—that is what I was alluding to earlier—for example, in certain markets, certainly in the New York Stock Exchange, under Mr. Phelan, a more aggressive willingness to try to enforce laws. That doesn't mean he has had it all easy, or that he has done everything right, but he has moved further than they did before in some areas.

I think in the futures industry you have got to see a willingness, first of all, on the part of the exchanges to want to get serious.

We have also seen, over time, that the quality of the staffs at the regulatory agencies is generally pretty good, and it is getting better, and there are an awful lot of committed people there that want to do the right thing.

Now, sometimes there are problems that the staff, just as in any organization, have disagreements on how far to go, there are discussions, and perhaps the staff want to be more aggressive than the Commissioners want to be.

So I think that it is very important to understand, not so much the staff, but what the regulatory philosophy and approach of the people are that you are appointing to the regulatory commissions, because they basically dictate how the commissions are really going to operate, and how the rules are finally going to be framed.

I think another area that we would—we think is very important, and even if you are not totally comfortable with where the Commissioners come from—is that if the Congress continually engages in good oversight and authorization hearings, and presses them, you can get the message across to them.

But I can't emphasize enough the importance of, I think, the philosophy that the Commissioners have, and also that the exchanges have. And, going back to an earlier question, that is why something like these undercover operations are important. Maybe it shakes up the exchanges enough that the leadership—and we have certainly seen it in their statements, are becoming more concerned.

But going to your initial question, I don't think we have seen anything that would lead us to say we ought to change the basic regulatory structure. I don't know that if you had put all of that responsibility right into a Federal agency, and said, basically, we are going to take it away from the SRO's, and do it all out of the Federal agency, that you would get any more effective regulation that if we kept it.

Senator **Kerrey**. Thank you.

The **Chairman**. Thank you. Senator Cochran.

Senator **Cochran**. Thank you, Mr. Chairman. Mr. Chairman, I think we all agree that the futures markets play a vital role in our economy, but in order to maintain customer confidence and credibility they need to be operated and regulated in an effective manner, and they must be free from fraud and illegal manipulation.

I hope the GAO and CFTC and the exchanges will continue their review of trading practices. I think this will help restore that needed credibility, and it will help the committee identify shortcomings which may exist in current CFTC and individual exchanges' regulatory practices.

But nothing should be done either, in my opinion, by the Congress or the CFTC, to diminish the value or the usefulness of the futures markets.

Do you see any of the proposals before this committee that would really do more harm than good?

Mr. **Fogel**. Well, I think the key one we have been discussing is the need for providing better a better system so you can enhance the integrity of these markets, so you therefore ensure their long-term viability.

So, in terms of what we have been discussing today, I would see these all on the positive side of the ledger, not that they do more harm than good.

Senator **Cochran**. Thank you, Mr. Chairman.

The **Chairman**. Thank you.

Mr. Fogel, I thank you and your colleagues very much. It is good to see you all here again, and I suspect this probably will not be the last time. Again, I applaud you for the work that you have done. You have been a great help to this committee.

Mr. **Fogel**. Thank you very much.

The **Chairman**. Thank you all.

[The prepared statement of Mr. Fogel appears at the conclusion of the hearing.]

The **Chairman**. Before we start with the next witness, I ask the committee to indulge me briefly on a statement just to give some idea of where we are at this point.

STATEMENT OF HON. PATRICK J. LEAHY

FUTURES LEGISLATION

We have now heard both from the Justice Department, through its indictments, and from the GAO this morning on their findings with respect to trading practices in the futures markets. To me, anyway, there are several conclusions that are inescapable.

I will give the bad news first, then the good news. On the minus side:

First, up through this year, the exchanges and CFTC have not done enough to police the futures trading pits against crimes and abuses by floor personnel. As a result, in some cases, it appears that abuses have apparently abounded.

Second, the audit trail systems, which are central to the ability of regulators to monitor floor trading, are not adequately designed to catch or deter a large number of violators and violations.

Third, the CFTC does not now have the resources to do its job effectively. Its staff has not grown to keep pace with the industry; in fact, its legal powers are limited.

I regret these conclusions. But one cannot read the Chicago indictments, the GAO report, the CFTC rule enforcement reviews, and the record before this committee, without being very concerned about demonstrated failings in the futures oversight system.

On the plus side, the exchanges and the CFTC—prompted largely by public pressure following disclosures of the Chicago and New York probes this year—are tightening their programs. Audit trail enhancements, tougher penalties, expanded compliance staffs, stronger trading rules, all are healthy steps and I applaud them. But they are not enough.

Now it is time for the Congress to act.

I have instructed the committee staff to begin drafting a bill to correct the regulatory gaps demonstrated by these recent events. I want to work with every member of this committee, the CFTC, and the industry to ensure that our proposal is effective, workable, and responsible. We face a crisis in this area; strong medicine is needed.

Having said that, I wanted to mention again that there are an awful lot of Senators from both parties who are very concerned about this problem. There are many people within the industry who are very, very concerned, people whose personal integrity is unquestioned. There are also a lot of people within the CFTC who join in wanting to see changes.

As part of this legislative package, I will urge the committee to adopt the central recommendation of the GAO that futures exchanges must implement new, precise audit trail technologies within, say, something like 3 years. The exchanges have committed sizable resources to this goal, most visibly through the joint initiative by the two major Chicago markets to develop hand-held computerized trading devices. Congress must insist that it be done.

I ask my colleagues to consider your own views toward the proper scope of the CFTC legislation so that we can begin working quickly toward developing a consensus bill to be introduced this month—during September. My hope is that this timetable will allow us to pass a bill through the Senate this year. There is no room for partisanship on this issue, and I do not anticipate any. We all agree that there is a need for reform. Now it's time to roll up our sleeves and do the hard work. We can do just that.

I now ask Mr. Hineman—Kalo, do you want to come up here and join us?

You might say that Kalo Hineman, Commissioner of the Commodity Futures Trading Commission, is no stranger to this table. He has testified, and testified well, before this committee on many occasions.

We're delighted to have you back.

Mr. **Hineman**. Thank you, Mr. Chairman.

The **Chairman**. Kalo, it is all yours.

STATEMENT OF KALO A. HINEMAN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC; ACCOMPANIED BY JOHN MIELKE, DIRECTOR, MARKET SURVEILLANCE; ALAN SEIFERT, DEPUTY DIRECTOR, TRADING AND MARKETS; AND STEPHEN BRAVERMAN, ASSOCIATE DIRECTOR, TRADING AND MARKETS

Mr. **Hineman**. Thank you, Mr. Chairman, for the opportunity to present the findings of the Commodity Futures Trading Commission, with respect to the emergency action where the Chicago Board of Trade ordered the liquidation of the largest positions in the July 1989 soybean futures contract.

Chairman Gramm asked me to convey to you her regrets that she is unable to be with you today because of a prior commitment to meet with international regulators of futures and options markets.

At this time I would like to stop a minute and introduce the people that I have up here with me. On my left, John Mielke, Director of Market Surveillance at the CFTC, and I am going to call on John at a particular time to show us some graphs and describe some of the things that Surveillance does.

I think it is better that I call on him to do some of that detail—I will do the general and call on him for some of the detail—so that you are talking to the person who probably knows as much about that as anybody in this world.

Likewise, when we are talking about the reviews, particularly about the members of the governing bodies at the Board of Trade, I am going to call on Mr. Alan Seifert for the details of that. I will do the general testimony, but feel free to ask any and all questions. Direct them to me, and we will do our best to tell you everything that there is.

It is my intent in this meeting to tell you as much as possible, because I think that is what is needed at this point in time.

Since we have now completed our review of the emergency action regarding the July 1989 soybean futures, I can present to you a complete report on that situation. By contrast, Chairman Gramm was constrained in her testimony to the House Agriculture Committee, since the event was still in progress, and the CFTC had just begun its review of all relevant factors.

That hearing coincided, time-wise, with active trading in the July soybean futures market. Chairman Mahlmann, of the CBT, testified a few days later, after the market was closed for the day and the July contract had already expired.

Obviously, one can speak more freely in retrospect than when trading of the contract is in progress, and he did so. I am fortunate at this time that the contract has expired, so openness and being able to speak in retrospect is possible. Let me give you a few of my own personal observations of our dilemma.

As a lifelong agricultural producer, I can tell you that I dislike Government actions that appear to make prices of agricultural commodities move to lower levels.

I can further tell you that I have an even greater dislike for situations that appear to prevent a futures market from providing reliable commodity price discovery, and which appear to render that futures market unreliable. These markets would then not be useful to hedgers, be they farmers, country elevators, processors, other end users, or exporters.

Futures market distortions severely restrict the ability of the local elevator—of my local elevator—to quote competitive prices for my grain, and could result in substantially lower prices being offered to me.

It is my firm belief that in such an instance a disorderly market would have a much more lasting effect, and create much greater havoc in all sectors in the producing, marketing, processing and retailing systems than would be the case resulting from swift and decisive action by regulators, such as was exercised in the July 1989 soybean futures contract.

Now that I have given you some of my personal observations, let me return to the Commission's review of the Chicago Board of Trade emergency action.

The dominant long position of Ferruzzi was being carefully observed by both the CFTC and the Chicago Board of Trade for several months prior to July. In May soybeans, jawboning by the CFTC and the Chicago Board of Trade market surveillance personnel was effective in securing sufficient reduction by Ferruzzi so that the contract liquidated in a satisfactory fashion.

However, concerns were then shifted immediately to the July contract. Through June and into July, continuing concerns were conveyed by the CFTC and the Chicago Board of Trade to Ferruzzi as to Ferruzzi's responsibility, under the Commodity Exchange Act, for orderly trading and an orderly liquidation of the contract.

Ferruzzi, rather than steadily and significantly reducing positions, actually increased positions marginally on a few days in early July. And, because of an overall reduction in total open interest, Ferruzzi had an ever increasing percent of the total long positions in the July contract.

The surveillance staff of the Commission, and the Commissioners, were acutely attuned to this situation. By July 7 it became clear to the Commission that an orderly liquidation was becoming less likely by the day.

Ferruzzi's failure to liquidate positions, coupled with the knowledge that we had that they owned 60 percent of the total soybeans in deliverable locations, made for a critical situation. Additionally, we knew that Ferruzzi's long positions were four times as large as the supply of deliverable beans in the delivery area, not already owned by Ferruzzi.

A time for action was at hand, and we acted. The Commissioners approved unanimously sending a letter to Ferruzzi which would rescind their anticipatory hedging exemption for the last 3 trading days of both the July and the August futures.

This decision was made on Friday, July 7. The letter was prepared and sent to Ferruzzi (by facsimile machine) the morning of Tuesday, July 11.

The Board of Governors of the Chicago Board of Trade, using their emergency powers, approved the following order on July 11, 1989, the same day, but later in the day. At that time there were 7 trading days left.

Any person who owned or controlled a gross long or short position in the July soybean futures exceeding 3 million bushels must liquidate that position by at least 20 percent per day.

By the close of trading on July 18, no person could have a gross long or short position exceeding 3 million bushels, and by the close on the contract's final trading day, July 20, no trader could have a position exceeding 1 million bushels.

The Board declared this emergency to ensure an orderly liquidation of the July soybean futures, but it did so only after extensive efforts to resolve this problem informally had failed.

The Chicago Board of Trade reached this decision based on its judgment of the appropriate actions that would be required to meet its self-regulatory responsibilities. The Chicago Board of Trade conferred with the CFTC, calling upon our expertise regarding available options.

However, the Chicago Board of Trade neither asked the CFTC which option we favored, nor did the CFTC offer an opinion. The CFTC responded as a regulator discussing technical issues with a self-regulator who was preparing to make a tough decision.

I believe the coordinated market surveillance efforts of the Commission and the Exchange were performed diligently and properly. We faced a serious market problem that, if ignored or treated too timidly, likely would have led to severely distorted July soybean futures prices, and could have resulted in contract defaults.

The decision by the Chicago Board of Trade to take this emergency action was an extraordinary event. However, it is one that not only is countenanced by Exchange and Commission rules, but also is the most difficult exercise of an exchange's self-regulatory obligations under the Commodity Exchange Act in the market surveillance area.

It also is subject to CFTC review, after the fact, from the standpoint of whether there was a reasonable basis for taking the action, and whether there was any abuse of authority or conflict of interest.

The Commission has completed a careful and thorough review of the trading of each member of the Business Conduct Committee, and the board of directors of the Chicago Board of Trade, as well as firms affiliated with those members, to assess the issues of conflict of interest and abuse of authority.

That analysis revealed no evidence of conflict or abuse. In conducting its review of the Chicago Board of Trade action, Commission staff reviewed the minutes of the board meeting of July 11, minutes for all meetings of the Business Conduct Committee held between May 1 and July 17, large trader reports, daily trade registers, clearing member reports, computerized trade reconstruction audit trail data, and certain individual account statements.

The Board action was approved by a vote of 16 to 1. No member had a position in July soybeans futures—no member on the Board of Governors, or on the BCC—the Business Conduct Committee.

Furthermore, 11 of those voting had no affiliation with firms with house or customer positions. There is nothing in the record to support the notion that an interested member tipped the balance in his or her favor, or in favor of another member, to the detriment of the public.

Much has been said about the impact of this emergency action on farmers. A few facts will put the impact of the emergency action in a clearer perspective.

Between July 5 and August 2, cash soybean prices at Decatur, Illinois, fell about a $1.50 a bushel. That price decline, however, cannot be attributed to the emergency action. Between July 5 and July 11, before the action was taken, the Decatur soybean price fell by 58 cents.

While the Decatur cash price fell 38 cents on July 12, it rose over 20 cents from that point until July 20, the expiration date of the July future.

From that date, July 20 until August 2, the Decatur soybean price fell 75¾ cents per bushel. As the data and charts appended to this testimony illustrate, similar soybean price trends occurred at other locations during these same time intervals.

I am going to ask John Mielke, when I finish here, to show you those charts, and I think they are very revealing.

Clearly the largest price declines in cash markets for soybeans occurred before and after the period of the emergency action. At most, part of the price decline on July 12, the day after the action—the action was taken after trading closed on the 11th—could be attributed to that action, and most of that decline was recovered before the July contract expired.

A comparison of the cash corn and soybean prices further illustrates this point. Between July 5 and 11, central Illinois soybean prices declined 8.7 percent, while central Illinois corn prices declined 9.1 percent—a bigger decline on corn.

Similarly, from July 12 through July 20—the period of the emergency action—central Illinois soybean prices fell 1.6 percent, while comparable corn prices fell 3.6 percent. Corn and soybeans were both affected by favorable weather during this period, while only soybeans was the subject of an emergency action. Yet corn prices fell more on a relative basis than did soybean prices.

This leads us to conclude that the emergency action had a minimal effect on prices to farmers when viewed from a perspective broader than one market on one day.

Farmers benefit from even-handed regulation that protects the futures markets from abuse. Had the Chicago Board of Trade not acted in July, and had July soybean futures prices risen sharply as a result, farmers probably would not have benefited from the price distortion, and they may have been hurt.

Farmers would only have benefited if they owned soybeans that could have been moved to the Chicago or Toledo delivery points by July 30, the last day delivery notices could be issued. That is true because a distorted futures price is a temporary, localized one, that will not be sustained past the delivery period, and will not extend to the entire cash market.

Since most users of soybeans, anticipating a problem in the July future, had switched their bids to the deferred delivery months well before the emergency action, their cash bids would not rise with a distorted future.

Furthermore, if a farmer or country elevator had a short hedge in the July future, they could have been doubly hurt. They would have to pay margin calls on their losing short futures position, but their stocks of soybeans would not have risen in value by an equivalent amount.

A distorted futures price would have adversely affected their hedges. Hedgers that may have been forced to liquidate at that point may have suffered significant losses. It is very important to keep in mind that a distorted futures market adversely affects a hedged position.

Now, Mr. Chairman, I wish to have John Mielke proceed with the charts that he has to show us concerning soybeans and some relationships between soybeans and corn that I talked about.

The CHAIRMAN. Go ahead.

Mr. MIELKE. The charts I am going to refer to will deal quickly with a couple of points, and they are all contained within the prepared testimony itself, appended to it. We have some additional copies—I do not know if they were circulated for those who may not be able to see the easel.

I would like to talk briefly about two points. One, the composition of the futures market going into the emergency, which will give you an idea of why we and the Chicago Board of Trade were concerned. It will also give you an idea about how the emergency impacted various people and, secondly, how it would illustrate some points with respect to the potential for a price impact arising out of this emergency.

The CHAIRMAN. Mr. Mielke, if you will withhold just a second, I would note for the other Senators that while this chart is provided by the CFTC reporting the traders as "A" through "J," the actual names of the various traders involved are available to individual Senators.

Any Senator who wishes to see this background information, it has been provided to Senator Lugar and myself, and you can see it here in the committee files. Any Senator can read it.

There are some other areas in which we will specify names. On this particular one, though, the names are available to the Senators.

Go ahead.

Mr. MIELKE. This is appendix 5, for anybody who has the prepared testimony. It shows the largest 10 traders on June 29, which is the day before the first notice day of the July future, and then the positions of those same traders on July 11, which is the day that the Board of Trade determined to take its emergency action after the close of trading.

One of the significant things to note here is the composition of the overall market on the 11th, in which one trader, Trader A, the largest long on the market, had a position of about 20.5 million bushels long, which accounted for 59 percent of the open interest.

No other trader, long or short, had anything close to that size in this market.

Also, if you look at the changes of positions, for all of these 10 traders between the 29th and the 11th, we notice significant reductions of all the positions except the largest long. While that long futures reduced its position somewhat, I think about 12 percent, its share of the market went from 36 percent to 59 percent. The largest short, by contrast, went from 9.5 million to just a little less than 4 million bushels, for a reduction of 60 percent. Five of these other traders dropped out of our surveillance reporting system altogether as they dropped below the reporting level.

We were getting substantial liquidations of positions except one, and that one is the one that was of the most concern to us.

The second chart, which is appendix 6 in your appendix, shows all reportable traders in the July soybean future as of the close of business on July 11, ranked by size. The CFTC reporting level is 500,000 bushels. This further illustrates the composition of the market.

There is only one large position in the market, either long or short. All other positions are much smaller than that. You can see the second largest long is less than 10 percent of the size of the position of the largest long in the market.

Again, the short positions, none of them are large. They are widely disbursed. Only one of them is above the speculative position limit level of 3 million bushels.

Most of the short positions, however, are all commercial positions. We have commercial type indicator here—"C" indicating commercial, somebody who is in the business and trading for their business, and an "N" indicating a noncommercial or speculator. And we have also indicated an "F" next to the trader if a significant portion of that position is held by a foreign parent or affiliate.

All but one of these short positions were held by commercial firms. However, only one or two of these positions were held by people who would customarily be in a position to deliver on the market.

Another thing you can look at by examining this chart is the impact of the emergency order on traders. The first aspect of the emergency order is that by July 18 traders had to reduce their position to 3 million bushels or less. And two people were affected by that first cut.

The second part of the emergency order was that by the close of business on July 20, the expiration date of the contract, everyone had to be below 1 million bushels, and there were a total of six traders that were affected by that order.

The second thing we would like to look at is the price impact question.

I think it is important to look at the price impact question from the perspective of what the market had been doing before and after the emergency.

In the summer of 1989, there was a lot of concern in this country that the drought of 1988 would be repeated, and particularly before the Fourth of July weekend, there was a large upsurge in grain prices, more than 50 cents in central Illinois soybeans, because we had had dry and hot weather up to that point in the critical growing areas.

However, after that Fourth of July weekend, there was significantly cooler weather, substantial rainfall, and we began to see a significant decline in soybean prices. I've highlighted, through the period July 11 through July 20, which is the emergency period. It shows what the price volatility was during that period compared to what happened before and after. And you can see there are much more substantial drops in the price of soybeans both before and after the emergency than there was during the period of emergency.

What we're seeing over the course of this period from July 5 to about August 4 is the removal of the threat of another drought from the soybean market.

This chart, which is appendix 11, calculates the actual soybean cash price changes for a number of cash markets. Decatur, Illinois; Des Moines, Iowa; Decatur, Indiana; a Gulf Barge price; and the Upper Illinois River cash price, for various time periods. Before the emergency, after the emergency, on the one day after the emergency, July 11, when we had all the publicity, and for the remainder of the emergency, which was basically from the close of business on July 12 through July 20.

We could see we had much larger declines in cash soybean prices before the emergency, ranging from 63- to 40-cent declines, and much larger declines after the emergency, ranging from about 76 cents to over 90 cents a bushel.

We did have substantial price falls the first day of the emergency action, the 12th, roughly ranging from 31 to 39½ cents, but for most of these markets, it gained substantially thereafter. So over the broad course of this month, it is really fundamental supply and demand conditions that were driving this market. But there may have been a bump in the road on July 12 from the emergency action. But a lot of that is taken out of the market again, and soybean prices rose.

Another way of looking at this is comparing corn and soybean cash prices during this period, and we looked at briefly the period of July 5 through the 11th, and the 11th through the 20th, the emergency period. As Commissioner Hineman pointed out, there were larger relative declines in soybean prices, both in that period prior to and after the emergency, than during the emergency itself. The corn market fell more strongly than the cash soybean market.

The **Chairman**. Thank you.

Mr. **Mielke**. And there are other charts appended to the testimony that provide the status for individual markets.

The **Chairman**. Thank you.

Before we go on to those, let me ask Mr. Hineman this.

Based on the CFTC's investigation so far, are you satisfied that no Board of Trade Director had a conflict of interest, either personally or through positions held at an affiliated firm, in the July 11 emergency vote?

Mr. **Hineman**. I am, Mr. Chairman.

The **Chairman**. And to clear the air on another point, I understand that you have been authorized to disclose the names of the six Board members who were affiliated with firms holding net short positions in house or customer accounts.

Can you tell us who they are, and what is the status of your investigation of these particular directors?

Mr. HINEMAN. As I said, this is a most unusual situation, to be able to do this. But I think in this situation it's very important that it be done, and I'm glad that the Chairman asked us to do that. And then the Commission voted to approve it. And that's the way these things get released.

Those people affected: Karsten Mahlmann, Chairman, Chicago Board of Trade—would you repeat again, Mr. Chairman, what data you wanted?

The CHAIRMAN. I was asking if you were authorized to disclose the names of the six Board members who were affiliated with firms holding net short positions in house or customer accounts. Can you tell us who they are and what is the status of your investigation? And tell us the names of their affiliated firms.

Mr. HINEMAN. The first one would be Karsten Mahlmann, and his affiliated firm is Stotler & Company. The short house position would be 110,000 bushels.

The next one would be Burton Gutterman—Mr. Chairman, I'm going to have Alan Seifert do this.

The CHAIRMAN. Fine.

Mr. HINEMAN. He is more familiar with that chart than I am. This is not a chart that I have spent a lot of time on.

The CHAIRMAN. Thank you.

Mr. SEIFERT. Mr. Chairman, Chairman Karsten Mahlmann showed 110,000 bushels gross positions in the house account, 110,000 net short house, customer gross positions were 700,000 bushels long, 2,935,000 short. Customer net position therefore was 2,235,000 short.

Patrick H. Arbor, the Vice Chairman of the Board of Governors, his affiliated firm had in customer gross positions long 60,000 bushels, and short 480,000 bushels, for a net customer position of 420,000 bushels short.

Donald G. Andrew, his affiliated firm had customer gross positions of long 20,000 bushels, short 1,855,000 bushels, for a net customer position of 1,835,000 bushels short.

Burton J. Gutterman, who recused himself from the deliberations of the Board of Governors because he had a personal spread position, his affiliated firm had customer gross position of 40,000 bushels long, 70,000 bushels short, for a net customer position of 30,000 bushels short.

Lester Mouscher had house gross positions of 30,000 bushels long, and short gross positions of 125,000 bushels. And the house net position therefore was 95,000 bushels short, and the customer gross positions 200,000 bushels long and, therefore, net position of 200,000 bushels long in the customer position.

Mr. Irwin Smith, his affiliated firm has customer gross positions, long 15,000 bushels, short 360,000 bushels, for a net customer position of 340,000 bushels short.

Hal T. Hansen, his affiliated firm has house gross positions of short 910,000 bushels, therefore for a net house position of 910,000 bushels short. Customer gross positions were 1,415,000 bushels long, 2,215,000 bushels short, amounting to a customer net position of 800,000 bushels short.

Mr. **Hineman**. To finish answering your question, Mr. Chairman, the review is complete, and the list of companies should be in the hands of the Senators at this time.

The **Chairman**. OK. And could we have for the record the firms represented by those individuals?

Mr. **Hineman**. Yes.

[The material follows:]

CBT Directors present at July 11, 1989, board meeting affiliated with firms with net short positions in house or customer accounts:

Irwin N. Smith, Rosenthal-Collins; Hal T. Hansen, Cargill Investor Services; Karsten Mahlmann, Stotler & Company; Patrick H. Arbor, L.I.T. Americ; Donald G. Andrew, Shearson, Lehman, Hutton; and Lester Mouscher, Lee B. Stern & Co.

The **Chairman**. Have you found any evidence that any insider at the Board of Trade, either a director, staff, member, or anyone else, used any advance knowledge of the July 11 emergency order to trade for their personal self-enrichment?

Mr. **Hineman**. I have none. I have no such evidence.

The **Chairman**. And are you satisfied that there were no leaks, intentional or inadvertent?

Mr. **Hineman**. We are. Our investigations showed no leaks by anybody.

The **Chairman**. And are you satisfied that the Board of Trade Board, in adopting the July 11 emergency, was not trying, as someone suggested, to "get" Ferruzzi because it was either a foreign company or not part of the CBT "club"?

Mr. **Hineman**. I'm satisfied, yes, sir.

The **Chairman**. Did the Board members, in debating the July 11 order, generally know that Ferruzzi was the largest long position holder? Is there a way of telling?

Mr. **Seifert**. We didn't know at that time.

Mr. **Hineman**. Yes, they did know.

[Letter of Mr. Hineman to correct his testimony follows:]

COMMODITY FUTURES TRADING COMMISSION,
WASHINGTON, DC, *September 27, 1989.*

The Honorable PATRICK J. LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, Washington, DC.

DEAR CHAIRMAN LEAHY: Attached is a corrected copy of my testimony before the Senate Agriculture Committee on September 8, 1989.

Please note that on page 70 of the testimony I incorrectly stated that members of the Chicago Board of Trade's Board of Directors, in debating the July 11 emergency order, knew that Ferruzzi was the largest long position holder. Information gathered in the Commission's review of the emergency, particular interviews of Board members, however, indicates that only the Chairman of the Board, Karsten Mahlmann, was aware that the Ferruzzi was the largest long. In fact, as you may know, it is the CBT's policy to redact names of market participants on materials distributed to the members of the Board during deliberations, such as occurred on July 11.

If you have any questions with regard to the enclosed testimony, please do not hesitate to contact my office at (202) 254-6318.

Sincerely,

KALO A. HINEMAN,
Commissioner.

The **Chairman**. OK. Since the CFTC had already revoked Ferruzzi's hedge exemption on July 11, was a CBT decree really needed?

Mr. HINEMAN. They have their role and their obligations; we have ours. Ours is an oversight regulatory role, as you understand, and theirs is the self-regulator.

In this particular instance, we each have a responsibility to these markets. And in these kinds of situations, our market surveillance people and their market surveillance people are talking to each other, and did, right from beginning way early last spring, and a little into last year, monitoring this situation very closely and sharing information with each other as to what they were finding out.

Beginning on July 5, when the July contract really became more of a concern, both the Chicago Board of Trade and the CFTC had continually escalated our surveillance until it was getting up to a pretty high level.

Having sat through some CFTC market surveillance meetings, which the Commissioners did, the Commissioners were also very much attuned to everything that was going on along the way.

We had been jawboning with the Ferruzzi group, reminding them of their responsibility to orderly marketing and to an orderly liquidation. The Chicago Board of Trade had been too. And through that period of time between then and the emergency, at the time we took our action and they took theirs, there were meetings between the Ferruzzi people and the CFTC. There were meetings between the Ferruzzi people and the Chicago Board of Trade, the market surveillance people in each instance.

The CHAIRMAN. Thank you.

Mr. HINEMAN. When we took our action, which was a letter removing the hedging exemption, at that point in time, in our opinion, that was a proper move, and I still think that it was.

At this point in time, I think one has to realize that the situation changes by the hour and by the day as you come down into the delivery procedure, and you see the tremendously large, four times larger long positions than you have deliverable beans available, you had better be concerned.

The CHAIRMAN. Thank you.

Mr. HINEMAN. And to see how that is all going to fit together. And time is of the essence, and you need to see some action. And we were not seeing action.

The Chicago Board of Trade, that afternoon, decided to—in essence what they did was to put a schedule of reductions that the Ferruzzi group needed to follow, with which we have no quarrel.

They independently arrived at their decision; we independently arrived at our decision. Are they that much in conflict? I don't think so.

What would we have done a few hours or a day later, nobody knows.

The CHAIRMAN. I have exceeded my time. I will yield to Senator Lugar and Senator Conrad.

Senator LUGAR. Mr. Chairman, before you leave, I would like to ask permission to place a statement by David Swanson of the Ferruzzi Group into the record at this point.

The CHAIRMAN. Yes, that and any other statements. We want them.

Senator LUGAR. Thank you, sir.

[The prepared statement of David H. Swanson of Gruppo Ferruzzi follows:]

GRUPPO FERRUZZI,
September 7, 1989.

The Honorable PATRICK LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Ferruzzi Group appreciates this opportunity to comment on events and issues related to the Chicago Board of Trade (CBOT) July 11, 1989 emergency order for the liquidation of July soybean futures, and the inquiries being conducted by the Commodity Futures Trading Commission (CFTC) into this matter. I am David Swanson, a member of the Ferruzzi Group's executive committee on agribusiness, and president and chief executive officer of Central Soya Company, Inc., representing the Ferruzzi Group's views on this matter.

The Ferruzzi Group, as a major producer, buyer, processor and exporter of soybeans, depends upon the orderly operation of the futures markets as a major hedging and price discovery mechanism. It strongly supports the CBOT's historic role as the worldwide reference market for free trade, and it has a clear stake in supporting the CBOT and the CFTC in their regulatory responsibilities. Ferruzzi has always met its obligations as a responsible market participant.

We believe our experience as a worldwide trader in grains and grain products, as well as our substantial position in the July 1989 soybean futures, give us a perspective that may be useful to the Senate committee in its deliberations.

We are concerned about the unwarranted emergency action taken by the CBOT. The order disrupted the market and artificially depressed prices, causing financial losses not only to Ferruzzi but to many U.S. farmers.

According to the U.S. Department of Agriculture price index report for August 1989, the cash prices paid to soybean farmers plunged in August, marking the greatest month-to-month drop in the past 5 years. Government analysts said the drop was due in part to the CBOT action.

The July 11 order, issued despite the lack of a genuine emergency in July soybean futures, suggests some misperceptions on the part of the CBOT regarding the futures market's use as a hedging mechanism. The CBOT does not appear to understand fully the needs of an international trader such as Ferruzzi, nor the manner in which a crusher and exporter delivers on its worldwide obligations.

The CBOT is viewed and respected by the rest of the world as the premier vehicle for price discovery in the commodities market. That market is increasingly global in nature. The CBOT must have the resources and the perspective it needs to fully serve the international marketplace.

It is essential that the CBOT and the CFTC carry out their oversight duties strongly, vigorously and in strict compliance with applicable standards and regulations. Market participants have a fair and reasonable expectation that the CBOT will treat all the parties involved in an objective, even-handed, and carefully considered manner.

The CBOT order is a matter of concern not only to Ferruzzi, but also to many U.S. farm trade organizations and grain producers. Ferruzzi depends on the crops produced by U.S. farmers and has has enjoyed a long, mutually beneficial relationship with them.

The facts presented in the CFTC's preliminary report dated August 25, 1989 are cause for further concern among market participants. These facts raise the disturbing question of a potential conflict of interest among certain CBOT directors.

The issue of the CBOT's emergency order, and these preliminary findings, deserve thorough inquiry by the CFTC and the Senate committee, with findings presented and analyzed in a public forum. Ferruzzi supports the CFTC and the Senate Agriculture Committee in their inquiries and stands ready to cooperate in whatever way it can.

The Ferruzzi Group

The Ferruzzi Group is a $30 billion worldwide conglomerate based in Italy. In the United States, it has operations in the agribusiness, chemicals and pharmaceutical industries, employing more than 5,000 people in 26 states. In 1988, Ferruzzi's U.S. revenues were approximately $4.5 billion, making it one of the leading international firms doing business in the United States.

Ferruzzi has long been active as a U.S. processor and exporter of grains and grain derivatives.

The company began exporting U.S. grain in the 1950's. Today, it is a major exporter of U.S. soybeans to the Soviet Union, Europe and Africa, backed by a large, integrated organization for handling and shipping grains, oilseeds and derivatives. Ferruzzi U.S.A., the group's grain trading arm, has two major export grain elevators in New Orleans and Baltimore in addition to five regional elevators in the Farm Belt.

Central Soya Company, Inc., based in Fort Wayne, Indiana, is a major soybean purchaser, processor and exporter. The company, founded more than 50 years ago, processes through its U.S. plants 10 percent of all soybeans crushed within the United States. Central Soya is one of the four largest soybean processors and the second-largest producer of animal feeds in the United States, with processing plants capable of crushing 150 million bushels of soybeans annually.

The soy proteins, feeds, oils and other grain derivatives that Central Soya's processing plants produce are exported worldwide, supporting and encouraging a strong market for U.S. grain.

Ferruzzi has been a member of the CBOT since the 1970's. Central Soya has been a member of the CBOT for more than 30 years; it also is a member of the Clearing Corporation of the CBOT. Ferruzzi is a hedger on the futures markets based on CFTC and CBOT hedging criteria. The company and its U.S. operations have had a long, cooperative relationship with the CBOT and the CFTC.

Ferruzzi's Hedging Activities

Ferruzzi, like other commercial traders and processors, uses the soybean futures market as a hedging mechanism to limit its price risk in meeting processing and export obligations.

The severe drought of 1988 and the resultant reduction in the U.S. soybean crop have underlined the importance of hedging as a price risk management tool. Ferruzzi routinely has taken long hedging positions over the past 12 months to protect against price fluctuations on processing and export contracts.

Through its compliance with reporting requirements, its willingness to meet with the regulatory bodies and its own voluntary actions, Ferruzzi has kept the CBOT and the CFTC apprised of its hedging activities.

May Liquidation

In May, Ferruzzi met with the CBOT's Business Conduct Committee to discuss Ferruzzi's long position in May futures. As part of this process, Ferruzzi voluntarily supplied copies of proprietary contracts outlining its crushing and export obligations—the reason for its hedging position.

Ferruzzi also met with the CFTC to review its position, present substantiation of Ferruzzi's soybean needs and answer any questions the CFTC had.

Ferruzzi offset its May futures position as it continued to process soybeans, fulfilled grain derivative and soybean export commitments and bought soybeans on the cash market. The May futures contract resulted in an orderly liquidation.

Based on this situation, Ferruzzi had no reason to anticipate that the regulatory bodies would seek to assure the liquidation of the July futures contract in a markedly different manner.

Ferruzzi's July Position

Ferruzzi's long position in July futures also was well-known to the CBOT and the CFTC. Twenty-three million bushels may seem like a large quantity to those unfamiliar with the operations of a worldwide grain trader and processor. But for a company such as Ferruzzi, the 23-million-bushel July long position simply reflects the volume required in the course of doing business.

Put into perspective, 23 million bushels is the quantity Central Soya needs to operate its crushing plants for about 50 days. This does not take into account Ferruzzi's export needs.

July Activities

On three separate occasions at the end of June and the first part of July, Ferruzzi and Central Soya met with CBOT and CFTC officials to discuss its position.

During this period, when long position holders are able to take delivery on July futures contracts, Central Soya began aggressively bidding in the cash soybean market. During the first week of July, the cash price in some locations appeared to be comparable to, or below, July futures prices. But these prices do not reflect the quantities available nor the transportation costs involved in moving the soybeans from those locations to a Central Soya plant.

Thus, such statements as that in the CFTC report, that market conditions "apparently would have made it economical for a long . . . to acquire soybeans in the cash market and lift its long hedges" (CFTC Preliminary Report, August 25, 1989, page 10), are inaccurate. They fail to reflect considerations of quantity and transportation that are an integral part of buying and receiving soybeans.

Assertions that cash beans were available at a lower cost than July futures levels also are inconsistent with the CFTC's and CBOT's statements that the signs of a disorderly liquidation were present. If, indeed, cash beans were available at an attractive price, those with short July positions should have been able to make good on delivery.

From July 5 to July 11, Ferruzzi had reduced its long July futures position by approximately 4.5 million bushels. This is well-documented and calls into question statements by the CFTC in its report, and by the CBOT elsewhere, regarding Ferruzzi's "apparent unwillingness to cooperate to ensure an orderly liquidation of the July future" (CFTC report, p. 10).

At this point, 7 trading days remained before the expiration of the futures contract. For a major trading company, this represents more than a sufficient amount of time in which to liquidate its long position in an orderly manner.

Steps Taken by CFTC, by CBOT

The CFTC on the morning of July 11 sent Central Soya a private letter stating that the CFTC would not consider as bona fide hedges any positions held by Ferruzzi operations against anticipated processing requirements during the last 3 trading days in the July and August soybean futures contracts.

The effect of this notification was to require that Ferruzzi's long position be reduced to no more than 3 million bushels by July 17. Clearly, Ferruzzi would have complied with the CFTC's letter. Ferruzzi has always recognized and respected the CFTC's authority to take steps to ensure an orderly liquidation.

The CFTC's action was market-neutral, and it gave Ferruzzi the time and the flexibility to liquidate in a logical, economical manner. More importantly, because the notice was issued privately, the CFTC action would not have disrupted the market.

Ferruzzi was not, however, allowed to proceed in compliance with the CFTC notice. Before it could do so, on the afternoon of July 11, the CBOT publicly issued its emergency order.

Specifically, the CBOT ordered all traders holding futures positions in excess of 3 million bushels to reduce their positions to that level by liquidating at least 20 percent of their positions each trading day through July 18.

To Ferruzzi's knowledge, Ferruzzi was the only market participant at that time with a long position in excess of 3 million bushels.

Consequences: Cash Prices Paid to Farmers Plunge

The CBOT's emergency order had the effect of artificially depressing the price of cash soybeans. The CFTC report, in its response to a question asking the effect on prices paid to farmers, says, "The available evidence indicates that it (the CBOT emergency order) did not have a significant effect on the cash price of soybeans" (CFTC report, p. 28).

But it is unclear upon what evidence the CFTC bases that conclusion. The U.S. Department of Agriculture, in its monthly price index report, found that cash soybeans plunged a full 90 cents a bushel for August. Average soybean prices fell to $5.93 a bushel in August from $6.83, representing the steepest month-to-month decline in 5 years, according to the USDA report.

Commodity analysts cited in the report attributed the collapse of soybean prices, at least in part, to the CBOT's action. According to newspaper coverage of the USDA report, the emergency order and the resultant forced sales of futures "not only caused soybean futures prices to plunge, but also drove down cash prices received by farmers, the analysts said." (Wall Street Journal, page B 1, September 1, 1989).

Less measurable but equally significant is the damage the CBOT has done to its credibility with U.S. farmers. The crops produced by America's farmers are the underpinning of the commodities market.

Farm products drive the grain-processing industry, which provides employment for tens of thousands of workers in the United States. These processed products in turn support the livestock industry and consumer product companies worldwide that use refined grain derivatives in their own products. Farmers clearly contribute to and help drive a healthy economy in the United States.

Many major trade and farm associations such as the American Soybean Association, the National Farmers Organization and the Illinois State Farm Bureau, as well as the Minnesota State Secretary of Agriculture, have questioned the need for the CBOT order. As participants who depend upon the market's orderly functioning, these groups also are urging a full inquiry into the thinking behind the CBOT decision.

The potential for a possible conflict of interest among some CBOT directors who participated in the emergency decision, in particular, warrants further attention.

Information presented in the CFTC preliminary report indicates that 5 of the 19 directors who participated in deliberations were affiliated with trading firms that had significant net short positions in July soybean futures in house and/or customer accounts.

To the extent that a given director has a financial interest in the firm, and insofar as he or she had knowledge of these short positions, there is the potential for a conflict of interest. It is important to the CBOT's integrity and to concerned constituents that the CFTC pursue full inquiries into this issue.

The CBOT Action was Inappropriate

As the CFTC notes in its report, the governing board of an exchange has the legal authority to impose temporary rules "in the event of an emergency."

Commission regulations define "emergency" as "any occurrence or circumstance which, in the opinion of the governing board of the contract market, requires immediate action and threatens . . . the fair and orderly trading in, or the liquidation of or delivery pursuant to, any contract . . . on such contract market."

Ferruzzi respects and supports the CBOT's responsibility to take action in the event of an emergency. However, based upon the facts, one cannot find evidence indicating an emergency. There is no apparent justification for the CBOT's immediate adoption of an emergency act.

Two sets of facts, indeed, offered assurance of an orderly liquidation.

1. *Ferruzzi, as outlined above, already had begun taking substantial steps to liquidate its position. These steps do not appear to have been taken into account when the CBOT made its decision.*

Ferruzzi's ongoing communications with the CBOT and the CFTC, its stated willingness to lift its position in a manner that made economic sense and its July liquidation activities argue against the necessity for such drastic action.

2. *The CFTC action of July 11, preceding as it did the CBOT order, provided further assurance of an orderly liquidation. The CFTC letter described above would have achieved the same legitimate regulatory aim of ensuring that long July positions were liquidated in an orderly manner. In this regard alone, the CBOT order was inappropriate and unnecessary.*

Moreover, the specifics of the CBOT order varied widely from that of the CFTC. The CFTC order was private and permitted flexibility; the CBOT implemented a forced, day-by-day liquidation, and it made the order public.

The effect of this public order was to make all market participants aware that there would be a forced liquidation of all long positions and that supplies would be more than adequate to ensure July deliveries.

The order, by virtue of the way in which it was shaped and presented, seriously disrupted the smooth functioning of the market and unnecessarily depressed the price of cash soybeans, to the detriment of U.S. farmers.

Summary

On July 11, 1989, the CBOT issued an emergency order that was unnecessary and disrupted the normal functioning of the soybean cash and futures markets. Ferruzzi believes that the CBOT's decision:

- Was made absent an emergency, and without adequate thought given to the potential market consequences.
- Failed to take into account Ferruzzi's July liquidation activities and the CFTC's own action to abate concerns regarding an orderly liquidation.
- Created results that were not in the best interests of farmers, a large and important constituency.

The CBOT, in its action, showed an apparent lack of knowledge about the needs of large international traders and the timetable and steps that major traders follow to ensure an orderly liquidation. The CBOT directors failed to consider their important responsibility for ensuring market stability and predictability worldwide.

For decades, the CBOT has been a self-regulatory body. For decades, it has been the world reference market for commodities, the centerpiece for free trade. Yet the CBOT's order raises questions about its future effectiveness.

Farmers and other major market constituents have a vested interest in the CBOT's ability to perform appropriately. They deserve to be assured that self-regulatory bodies are able to function in a manner that takes their interests into account.

The Ferruzzi Group, as a major market participant and a worldwide concern, wholeheartedly supports a strong, vigorous and effective Chicago Board of Trade. It further supports and respects the CFTC as the oversight agency that is accountable to Congress for the CBOT, and that helps to ensure that the market operates in an orderly, consistent, fair manner.

To ensure that this sort of incident does not occur again, Ferruzzi believes that steps must be taken to improve the level and continuity of communications among the CFTC, the CBOT and market participants.

If the CBOT is to continue to function effectively in the world marketplace, there also needs to be a greater level of understanding regarding the cash markets, the interrelationships between producers and users, and the needs and activities of international traders.

Ferruzzi urges the CBOT and the CFTC to take the lead in reaching out to all participants in the market to arrive at a better mutual understanding. By establishing such dialogues, the regulatory bodies take a critical step toward ensuring the CBOT's future as a worldwide reference market that serves the needs of all market constituents.

Ferruzzi is grateful to the Committee for being permitted to express not only its concerns, but what we believe are the same concerns held by many other producers and traders worldwide.

Very truly yours,

DAVID H. SWANSON.

Senator LUGAR. Mr. Hineman, I have just placed in the record a statement issued by David Swanson of the Ferruzzi Group, and I have used a portion of that statement to brief myself on the position taken by the Ferruzzi Group in this situation.

So I want the source of this information to be crystal clear. Obviously, he has a position which is a somewhat different one than the one taken by the Commission or the Board of Trade.

As Mr. Swanson, on behalf of Ferruzzi, views the issue, he believes that the Ferruzzi Group met with the Board of Trade's Business Conduct Committee in May to discuss their long position in May futures. As a result of this discussion process, Ferruzzi voluntarily supplied proprietary information outlining their crushing and export obligations, and the reasons for its hedging positions.

In addition, they met with the CFTC to review the position and to present substantiation of Ferruzzi's soybean needs, and answer any questions of the CFTC.

Apparently, as a result of all of these discussions, Ferruzzi offset its May futures position as they bought soybeans in the cash market for processing and soybean export commitments. As a result the May futures contract had a normal liquidation.

They claim, based on this situation, Ferruzzi had no reason to anticipate the regulatory bodies would seek to assure a liquidation of the July futures in the market in a different matter.

Their recollection of July is that their position in July futures is also well known to CBOT and to the CFTC. They indicate that 23 million bushels may seem like a lot of quantity to those unfamiliar with the operation of a worldwide grain trader, but Ferruzzi claims that the 23 million July long position reflects the volume needed in the course of doing business, and specifically the crushing plant requirements for about 50 days at Central Soya.[1] And they say this does not take in consideration their export needs.

So their claim is that 50 days of crushing is not a disproportionate supply to have on hand, given the size of their operations. However, on three separate occasions, at the end of June and in the first part of July, Ferruzzi and their subsidiary, Central Soya, met with the CBOT and the CFTC officials to discuss the positions. So apparently all of the data was well known to everybody involved.

During this position, when long position holders are able to take delivery on July futures, Central Soya began aggressively bidding in the cash soybean market. This is the impression that I gathered from earlier testimony, that the soybean cash market ought to have been the place where Central Soya should have sought cash beans. Ferruzzi states that they became very active in that market. And during the first week of July, the cash price in some locations appear to be comparable to or below, as you've stated, the July futures prices. But these prices in their judgment do not reflect the quantities available in the cash market nor the transportation costs involved in moving the soybeans from those locations to a Central Soya plant.

Thus, they say that the statements in the CFTC report that market conditions would have made it economical for a long to acquire soybeans in the cash market and lift its long hedges are inaccurate. Ferruzzi says these statements fail to reflect considerations of quantity available and transportation, both an integral part of buying and receiving soybeans.

Ferruzzi also claimed that from July 5 to July 11, it reduced its long position in July futures by approximately 4.5 million bushels. And they claim that fact is well documented in statements of the CFTC and in a report written by the CBOT regarding Ferruzzi's "apparent unwillingness to cooperate to ensure orderly liquidation."

In any event, at this point, 7 trading days remain before the expiration of the futures contract, and they claim that for a major company, this represents more than a sufficient amount of time to liquidate the position of that size.

Now, they point out that on July 11 the CFTC sent Central Soya a private letter, a private letter stating that the CFTC would not consider as bona fide any hedge positions held by Ferruzzi operations against anticipated processing requirements during the last 3 trading days in the July and August soybean futures contracts.

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[1] Central Soya Company, Inc., based in Fort Wayne, Indiana, is a major soybean purchaser, processor, and exporter.

The effect of this notification was to require that Ferruzzi's long position be reduced to no more than 3 million bushels by July 17. Mr. Swanson asserts that clearly Ferruzzi would have complied with the CFTC's letter. Ferruzzi has always recognized and respected the CFTC's authority to take steps to ensure an orderly liquidation.

In the judgment of Mr. Swanson, CFTC's order was market neutral, gave Ferruzzi the time and flexibility to liquidate in a logical economical manner and, more importantly, because the notice was issued privately, the CFTC action would not have disrupted the market.

"Ferruzzi was," and I continue quoting from him, "however, was not allowed to proceed in compliance with CFTC notice. Before it could do so, on the afternoon of July 11, the CBOT publicly issued its emergency order.

"Specifically, the CBOT ordered all traders holding futures positions in excess of 3 million bushels to reduce their positions to that level by liquidating at least 20 percent of their positions each trading day through July 18.

"To Ferruzzi's knowledge, Ferruzzi was the only market participant at that time with a long position in excess of 3 million bushels."

Now, the point I want to raise, gets back to a question you were just responding to with Chairman Leahy. Ferruzzi's contention, and it is their contention, that they expected the CFTC's private letter would have resulted in orderly liquidation, and would have done so without disruption to the market. But, the same afternoon, the CBOT submitted an order, a very specific order, and a public one, that required liquidation occur by 20 percent a day for each trading day. This order clearly changed the market expectations.

These concerns also impact heavily on the question that Senator Leahy raised of you and you responded to, that members of the Chicago Board of Trade had short positions for themselves in some cases, or for their customers. And I suppose the question recurs that obviously one director apparently recused himself from voting on this situation, but apparently five others, according to my accounting did not. That raises a logical question, why not?

In a situation where people have a substantial interest for themselves and their customers, even if they indicate that they had no prior knowledge of the meeting or of the after-effects for the market it seems to me that common sense and prudence on the part of the president and vice president of the Board, to preserve the integrity of the situation, would have considered recusing themselves when the meeting to discuss the emergency order was called.

My own reading, I must say, and I do not ask these questions to judge them one way or the other, is that essentially the price effects of all of this probably, as you have stated, with the concurrent rainfall, led to a decline of speculative interest and into a backing and filling of prices through this period.

But, in terms of both the CFTC and the markets, the question clearly still arises, could not the purpose that CFTC sought, namely to counter a concern about an excessive position in the hands of one trader, have been accomplished through the CFTC letter. This would have avoided the action of the CBOT in what clearly has some appearance of potential conflict of interest when directors having short positions do not recuse themselves. Further, would not philosophically the whole picture of these markets have been better at this point if the CBOT had not acted in this manner and if the CFTC's proposed remedy would have proceeded in about the same manner in July as it did in May.

I really question your comment. You said, after all, CFTC is one thing, CBOT is another. Both have their own rules. Both have rights and privileges, and act whenever they want to do so.

But as the oversight agency, monitoring and preserving the integrity and confidence in the market, does CFTC really endorse what occurred by the CBOT on that date, and would it advise a different strategy if similar circumstances arose in the future?

Mr. HINEMAN. There are a lot of things to respond to in what you just read, Senator. And I will do my best to respond to those as we go along. And if I miss some of them, why, please jog my memory.

I think one has to do this from the standpoint, at both the CFTC and the Chicago Board of Trade, of approaching this with the same thoughts in mind—we have a responsibility to the market. And every day that passes there are fewer days left, and we do not see reduction, and we have not seen reduction, and we did not get the same kind of response throughout the July contract that we got in May.

We did not get the assurances, we did not have any kind of assurance that a reduction was going to happen. It did not happen. So there was nothing to lead us to believe that, all of a sudden, there was going to be a change and we were going to see the liquidations, and would they be orderly? And, in fact, everything more and more began to point the other way, that you had better expect that there could be congestion at the tail end, and definitely one thing we both knew, there was nowhere close to enough beans in the delivery area to satisfy those long positions if they decided to take all those beans, to stand for delivery on all those beans.

Senator LUGAR. Now, explain to us, just for the record, what would be the consequence of this? Obviously it has been mentioned with some foreboding. But let's say, just as you have stated, that there were not cash beans available in the area. What happens in a market if you approach the end of a contract and that occurs?

Mr. HINEMAN. The way the markets work, there would be an increased likelihood of a market default. You cannot deliver what is not there.

If the long stayed, hard and fast for delivery of that many beans, then there was going to be a market default. Why didn't they move more beans into the area? The futures markets basically were higher than the cash market.

That is a good question. Why didn't people move beans into the market? I have a couple of theories of my own. I do not think farmers wanted to sell at that price. That is one.

Also I think that the demand for old crop beans had kind of withered and gone away. As a wheat farmer, I have been in that position myself before. We are optimists.

Anyway, for some reason, there was not the active bidding in the cash market that there should have been, if there had been good demand. It just was not happening so it was a rather static situation.

We saw no one who knew what Ferruzzi was trying to do. In fact, the Chicago Board of Trade received a letter from them in which they said they were going to stand for delivery if thus and such did not happen.

I think we have to talk just a little bit about the fundamentals and the theory of a futures market. Futures markets basically work, in my opinion, because the large commercials want it to work. And they do not want to mess up those markets. And it is to everyone's best interest, regardless of their physical needs for product, to make sure that there is an orderly delivery or an orderly liquidation at the end of that market.

As far as their cash needs, we keep very close track, and we are in constant daily contact with them as to their real cash needs. We have a system—John is the expert, and I can tell you about that system if you would to hear about it, as to how we track the cash market, and their needs, and talking to them about their needs and their plans of liquidating their futures contracts.

There was not a lack of communication throughout this whole period of time.

Senator LUGAR. You feared potential default of the market. In other words, the dire circumstance which you understand perfectly well, but the public as a whole and many of us in the Senate would not understand as well, is that when you come to the end of the period, and the beans cannot be delivered, the whole market does not collapse, but it fails because, somehow or other, supply, demand and delivery do not equate.

Mr. HINEMAN. But at that point in time, you are talking about a delivery area, a small area. And there are books that could be written about multiple delivery points. And that is an issue that I have spent lots of time on.

But, in these kinds of markets, you finally come down to, what are you pricing. Are the beans available in a small delivery area, or what can be brought in there in a hurry? And so that is what you are really pricing.

There is another fear. I am not alleging that these things happened or did not happen, and I have no absolute knowledge that they would have happened. But these are the things that have to be foremost in your mind at that time. The other possibility is called a squeeze or a corner wherein, by the longs hanging tough, and the shorts are in the market and cannot get out, the price just spikes up which, in my opinion, does no one any good. The cash market does not follow.

If you are a hedger in there, if I was a farmer hedging in there, I would get margin calls from here to yonder and back again. And I would not have the ability to go to the cash market and sell my beans or, in my case, wheat commensurate with the price.

So, any way you look at it, it is an undesirable situation. It does not facilitate commerce, it does not provide the hedging function that it should, and it is not a usable, reliable price discovery market at that time.

Those are the reasons. And as I said in my testimony, when it comes to a choice between the two, that is a terrible choice to have to make. But I say that market default is by far the worst of the two. And I think, as we saw on the chart, there is disruption, no question. John said it is a bump. I think it is a big bump that was in there. But the market basically was following fundamentals.

And so that is what the regulators are there for, and they are there to make the tough decisions.

Senator **LUGAR**. How do you differentiate between the regulation you the CFTC provided and the action of the CBOT? Ferruzzi apparently accepted the fact that if you told them to liquidate, they would have gone ahead and done so.

But the letter from CBOT later in the afternoon with the specifics and the public notice and so forth changed the picture.

Mr. **HINEMAN**. It was a public notice, and that is different. But when you do something of that kind of market significance, I do not think anybody would argue but what you must really make it public.

And particularly because this was affecting both sides of the market, the longs and the shorts. And to have market information out there that the public did not have is a worse scenario.

Senator **LUGAR**. But they did not have your letter of July 11 anyway.

Mr. **HINEMAN**. They did not have our letter, that is true. But, on the other hand, if we started giving out all of our warning letters to the public—I do not think it is proper, and I am not even sure that it is legal. I do not think it is legal for us to give out public information as to those types of things that we do.

Senator **LUGAR**. Well, probably not, and I do not mean to——

Mr. **HINEMAN**. And I do not think that it should be either. The cure might be a lot worse than the disease.

Senator **LUGAR**. True. But, as I understand the Ferruzzi position, that was the case. In other words, if you had left things as it were with your letter, they would have liquidated. It was the next step that created the dilemma.

Mr. **HINEMAN**. You know, I hear that. I understand what they are saying.

If I were sitting on the Chicago Board of Trade at that point in time, I think I would understand what they were doing too.

They have a choice. Now, there is nothing in the regulations that say that their choice has to be the right choice, the only choice. And we have talked with them about four different alternatives that might have happened.

Would the CFTC have been comfortable with any of those four choices? I do not think any of them would have been the end of the world. Some of them we would have preferred more than others. That is not our call at that point in time.

And you have to remember that afterwards we are going to be the review body that comes back and reviews what has happened. I think that is a factor in all of this too, and I am glad we do that.

Senator LUGAR. Let me wind up my part because others have questions. To get to the point of why did the members who had the short positions for themselves or their customers not recuse themselves? It would appear to me it is not a good practice for Board members who have those sorts of positions to be voting on that kind of an issue.

Mr. HINEMAN. Excuse me, Senator, I did not hear that.

Senator LUGAR. Why did the members who had the short positions for themselves or their customers not recuse themselves? Is it a good practice for Board members to be voting, when they apparently have a very substantial self-interest for themselves and their customers in the outcome?

Mr. HINEMAN. You have come right down to the line. At some point in time, you have to make a judgment decision. Now, should we draw the rules so tight that a potential conflict could never happen? You know, it could be done.

But then, how many people are you eliminating from sitting there at a point in time when you need experienced people on these Boards?

We went behind those positions and did interviews. In this situation I can say with surety I do not think a conflict was there. It is a judgment call, is it best to go this way or is it best to go some other way?

Let me turn to Alan. He has something he would like to say on this.

Mr. SEIFERT. Senator, in further response to your question, I think that you asked early on why the one Governor recused himself, and the others who voted that had positions did not?

The reason for that is that the nature of the positions was materially different. The one Governor who recused himself had personal positions. He had a personal spread between the July contract on the Board of Trade and the Mid-America July contract.

The other five members of the Board who did not recuse themselves and participated in the vote did not own or control any personal positions. They had administrative positions of employment with affiliated firms. Those affiliated firms, not the individuals themselves had customer and house positions.

As to those customer and house positions, our interviews indicated and our review of the trading confirmed, that those individual Board of Governors did not have knowledge of the trading strategies being engaged in those accounts, nor did they have influence over those strategies.

So, in the first instance, there is a fundamental distinction between the individual who correctly recused himself and the others who did not.

Very quickly to some other points that I think are helpful to the issue is that there were 16 yes votes. Of those 16 yes votes, 11, or 65 percent, were cast by directors who had no personal and no affiliated firm positions. The other 5 only had affiliated firm positions.

And lastly, going to the point that Commissioner Hineman made, the standard of conflicts of interest that is inherent in the review of this emergency, is a standard that is consistent with judicial standards set forth in this area. And it is a balancing question of getting the requisite expertise so that an exchange can in fact engage in a meaningful decisionmaking process.

In this instance, had the 5 individuals with affiliated firm positions also recused themselves, you would have been left with 12 members who were capable of voting, which is the minimum quorum for a decision. It is easy to see how you can readily end up in a situation where individuals will not be able to participate to the point that there will not be a decisionmaking process.

Senator LUGAR. It is conceivable, but I think the predicament, which you well understand, is the charge that there were firms who either had positions or customer positions, in competition with Ferruzzi or hypothetically somebody else. What we are refereeing here is a battle between economic interests. This is why the problem of recusing oneself from voting on this becomes an important issue. Your response is technically an important addition as to why some people saw some responsibility, and why some others did not. But, in terms of public confidence in this situation, it has been portrayed as a way in which some firms protected themselves and their customers at the expense of another firm.

And this occurred after the CFTC had already issued a private letter which at least Ferruzzi asserts they would have followed in any event. The purpose of this hearing is to try to air all of this today so that honest men can differ and reach different judgments. But I raise the question just to try to illuminate what I think are the pertinent issues with regard to the future, quite apart from this past instance we witnessed.

Mr. HINEMAN. I think you are absolutely right, Senator, and in view of the future, I think we also have to keep in mind that different exchanges may be different. There may be a lesser pool side of capable people at some than at others which is an important concept.

But I want to thank Alan for coming through with that additional information, and it does help to go to the experts when you want the detail.

Senator LUGAR. Thank you very much. Thank you, Mr. Chairman.

Senator CONRAD [presiding]. It will be our intention now, since Senator Kerrey has to go, to have him ask his questions. And then I will ask mine, and then we will recognize Senator Daschle and Senator Harkin for theirs.

Senator KERREY. Mr. Hineman, I have not prepared written questions but what I intend to do here this morning is to ask three or four questions, and I would appreciate getting some answers back from you in writing.

The first one relates to the philosophy of the Commission toward the exchanges themselves, and specifically in this instance, it has to do with a question that Senator Lugar was asking about positions held by Board members, and for that matter, positions held by CFTC Commissioners.

As you know very well, perception very often is much more important than what in fact is going on.

So I would like in writing, if you could, what sort of evaluation the Commission has done of Board members holding positions.

And, for that matter, as I said, whether the Commissioners themselves hold any positions at all in the marketplace.

The second one has to do with liquidity. In this case, my concern is the soybean market, and whether or not you have been tracking the status of overall liquidity in soybeans and what impact that might have had upon the apparent ease with which someone could take the positions that would end up cornering the market or coming close to it?

The third question is—and I must say, as the graphs were put up here showing how the price really did not change much during the period of the emergency action, I am not personally very impressed by that because I must tell you that I read a newsletter called "Pro Farmer," and they were talking about a possible market squeeze on soybeans for weeks before this thing happened. Four weeks prior to the action taken, "Pro Farmer" alerted their farmer subscribers that something was going on and to be wary. So it seems to me that the period you tracked should have included the several weeks prior to the action.

Thus I would like some sort of statement as to the knowledge on the floor, particularly of the folks that might be much more knowledgeable in these matters, as to whether they knew if something was up.

The last thing that I would like to ask is if you intend to take any punitive action against Ferruzzi. It seems to me that what if you in fact hold, as you indicate, a strong position that they were wrong either in the way that they traded or that they in fact may have even cornered the market, then some action must be taken

What must occur here is something more than just a study and evaluation of this thing.

I am concerned about it because many soybean growers who did not hedge their risk, who did not forward contract their crop, were essentially long and exposed and suffered as a consequence of the activities that occurred.

So they are saying to me, OK, I just took a hit, what is the Commission going to do to Ferruzzi, or whomever is guilty? What sort of punitive action is the Commission going to take against the guilty party?

That is my last question, sir, and I would appreciate it if you would respond in writing.

Mr. **Hineman**. Senator, we will send you answers to those questions.

Senator **Kerrey**. Thanks.

[The requested information was subsequently provided for the record.]

COMMODITY FUTURES TRADING COMMISSION,
WASHINGTON, DC, *December 20, 1989.*

The Honorable J. ROBERT KERREY,
U.S. Senate, 302 Hart Senate Office Building, Washington, DC.

DEAR SENATOR KERREY: This letter is in response to several questions you raised regarding Ferruzzi Finanziaria S.p.A. and the expiration of the July 1989 soybean futures contract on the Chicago Board of Trade at the September 8, 1989 hearing before the Senate Agriculture Committee. The Commission apologizes for the delay in responding to these questions.

In your first question, you inquired "I would like to know what sort of evaluation the Commission has done of board members holding positions? And, for that matter, the Commissioners themselves holding any position at all in the marketplace?" In response, the Commission would refer you to the accompanying report by our Division of Trading and Markets which was issued on September 7, 1989. Pages 14 through 29, regarding "Absence of Bad Faith," provide a Commission staff analysis of board members' participation in recommending the emergency action.[2] No Commissioner of the CFTC held a position in the July 1989 soybean futures contract during the events leading up to, and including, the emergency liquidation order. As you may be aware, Commissioners of the CFTC are statutorily prohibited from holding any position in the futures markets.

Secondly, you inquired, "have you been tracking the status of overall liquidity of soybeans and what impact that might have had upon the apparent ease with which someone could take the positions that would end up cornering the market or coming close to it?" Our surveillance staff closely monitored trading in the CBT soybean futures market throughout the spring and summer of 1989. Ferruzzi, the largest long in soybean futures throughout that period, had established its net long futures position months before the July emergency action. Ferruzzi asserted that its long position was a hedge of a combination of export sales commitments and anticipated processing requirements. As each delivery month approached expiration, Ferruzzi took some deliveries and rolled the remainder of its long position into the next delivery month. The futures market had sufficient liquidity to accommodate the establishment and rolling forward of these large positions.

By July 1989, however, Ferruzzi had accumulated ownership of a very large portion of the deliverable soybean stocks and it owned a majority of the long open interest. This potentially dominant position, combined with concerns that Ferruzzi might not roll its July position forward, formed the threat to the market that led to the CBT's emergency action.

Your third inquiry made reference to an article appearing in Pro Farmer magazine advising subscribers weeks in advance that someone in the market was taking a significant long position in July soybeans which could be cause for concern. While the potential for a serious market problem could be discerned long before July 11, 1989, no one knew, other than perhaps Ferruzzi, whether that problem in fact would develop. It was only when Ferruzzi failed to liquidate or roll forward its long July futures position, despite strong requests from the regulators that it do so, that the situation rose to the level of a crisis warranting emergency action. Given the historic infrequence of such events, no one could have known the outcome in advance of the CBT's ultimate decision on the afternoon of July 11, 1989.

In response to your fourth question, "do you intend to take any punitive action against Ferruzzi?", this response has been provided to you in our letter of October 16, 1989.

I hope this information is helpful to you. If I can be of further assistance to you, please let me know.

Very truly yours,

KALO A. HINEMAN,
Commissioner.

Enclosures: Retained in committee file.

[Letters of the Honorable J. Robert Kerrey and Kalo A. Hineman, Commissioner, Commodity Futures Trading Commission, dated September 8, 1989 and October 16, 1989, regarding an inquiry whether CFTC planned to take any action against Ferruzzi Finanziaria S.p.A. (Ferruzzi) with respect to its activities in the July 1989 Soybean contract on the Chicago Board of Trade follow:]

UNITED STATES SENATE,
WASHINGTON, DC,
September 8, 1989.

The Honorable KALO A. HINEMAN,
Commissioner, Commodity Futures Trading Commission, 2033 K Street, NW., Washington, DC.

DEAR COMMISSIONER HINEMAN: I was pleased that you could appear before the Senate Committee on Agriculture, Nutrition, and Forestry this morning to provide the Commission's assessment of the events surrounding the emergency action by the Chicago Board of Trade (CBOT) involving the July, 1989 soybean futures contract.

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[2] Material is retained in the committee file.

The thrust of your testimony was that the CFTC has concluded that the CBOT acted properly in issuing its emergency order. It is thus apparent that the CFTC also has determined that Ferruzzi Finanziaria S.p.A. acted in a manner that fully warranted issuance of the emergency order, by engaging in either (1) improper trading practices (and failure to cooperate with the CFTC) or (2) a deliberate attempt to corner the soybean market.

In this morning's hearing I asked you to report back to the committee regarding any CFTC plans to take punitive action against Ferruzzi because, in my view, the Commission is under obligation, based on its conclusions, to take punitive action against the offending party, particularly if the Commission believes that Ferruzzi attempted to corner the market.

As a farmer yourself, you must know there is a widely held view among farmers that, in the end, after lengthy investigation and study, and accusations back and forth between the CBOT and Ferruzzi, nothing much will come of this latest upheaval in the futures market. If the image of futures trading is not to be further tarnished, and because the CFTC has apparently found fault in this case, I believe it is imperative that the Commission impose appropriate sanctions against the guilty party.

To this end, I respectfully request a response to the following questions:

(1) In the CFTC's view, did Ferruzzi's activities involving the July, 1989 soybean contract, which gave rise to the emergency order, constitute improper trading practices, a deliberate attempt to corner the soybean market, or some other trading offense?

(2) What authority does the CFTC have in this instance to ensure that the offending party is punished?

(3) What plans, if any, does the CFTC have to penalize Ferruzzi as a result of this episode?

I appreciate your attention to this request, and I look forward to hearing from you.

Sincerely,

J. ROBERT KERREY.

COMMODITY FUTURES TRADING COMMISSION,
WASHINGTON, DC, *October 16, 1989.*

The Honorable J. ROBERT KERREY,
U.S. Senate, Washington, DC.

DEAR SENATOR KERREY: This is in response to your letter of September 8, 1989, in which you inquired whether the CFTC planned to take any action against Ferruzzi Finanziaria S.p.A. (Ferruzzi) with respect to its activities in the July 1989 Soybean contract on the Chicago Board of Trade (CBT). The Commission had been assessing the activities of Ferruzzi prior to the time of your letter, and is pleased to provide you with this update.

Consistent with our keen desire to keep this Committee fully informed on this matter, we have deviated from what we believe in general to be a sound guideline in potential enforcement issues. That policy is that we do not comment on the existence of an investigation or intention to bring an enforcement action.

Based upon its review of all the information available thus far, the Commission has not commenced any enforcement action against Ferruzzi in connection with these events. However, the Commission continues its review of this matter.

The Commission, while the July and August contracts were trading, restricted Ferruzzi's use of the anticipatory hedge exemption from speculative limits on soybeans. This action was taken by the Commission to prevent the disorderly liquidation of soybeans. As you know, before this Commission action became effective in the July futures contract, the CBT took emergency action applicable to all market participants because of its concerns regarding the July futures expiration.

Commission Regulation 1.41 provides broad discretion for contract markets to take emergency action, including where there are circumstances that threaten or may threaten fair and orderly liquidation of or delivery pursuant to a futures contract. As the Commission has indicated, we believe that the CBT's action met this standard. However, the fact that an exchange has taken an emergency action does not require that an enforcement action be commenced.

While the events surrounding the liquidation of a futures contract may be of a magnitude sufficient to warrant exchange emergency action or even regulatory intervention by the Commission, it does not necessarily follow that the traders involved were violating the law.

If you have any further questions, I would be pleased to talk with you to answer them. Thank you for your continued interest in this matter.

Very truly yours,

KALO A. HINEMAN,
Commissioner.

Senator CONRAD. Thank you, Senator Kerrey.

Kalo, I would be interested to know if Ferruzzi, during this period, was asked for a commitment to liquidate their positions. That is, in those early days of July, was Ferruzzi specifically asked for a commitment to liquidate those positions?

Mr. HINEMAN. Yes, by the Chicago Board of Trade.

Senator CONRAD. And what was the answer?

Mr. HINEMAN. The answer was the July 10 letter, which essentially said we are going to maintain our July futures hedges if we are unable to get the beans in the cash market.

Senator CONRAD. And so your answer to that question would be, as I understand it, and correct me if I am wrong, that Ferruzzi refused to make any commitment on liquidating their positions?

Mr. HINEMAN. Yes.

Senator CONRAD. When did the CFTC first become aware of a developing problem with soybeans?

Mr. HINEMAN. You know, market surveillance is an ongoing thing, and thank goodness it is. And these things began to show up on the books even before the end of last year, but it was an ever escalating, slowly escalating thing all the time, to the first contract month where we really became concerned about how the liquidation was going to go which was with the May future.

Senator CONRAD. When did you become concerned about the May contract?

Mr. HINEMAN. We were concerned about the May contract even a little before it started. But all the way through, with the ever escalating position and the numbers that showed the position and the deliverable supplies, we were in constant touch with them at that time, and urging them to reduce their positions, and they were doing that. We were getting some response, not a big response, but it was a gradual steady response in May.

It started in early May——

Senator CONRAD. Give me a complete background because I think it is very important for the purposes of the record that we, with great specificity, indicate what was the first contact made between CFTC and/or the Board of Trade with Ferruzzi indicating a need to reduce positions?

Mr. HINEMAN. Senator, I want to turn you over to John Mielke, who is the person who actually was on the firing line doing those things at that time.

Mr. MIELKE. The first communications with those specific requests occurred on the May future in the latter half of the liquidation of that contract. Both we and the Board of Trade requested Ferruzzi to reduce its positions in the May contract. We specified some numbers. They met those objectives, and the contract expired.

Senator CONRAD. Can you give us a date when that first contact occurred?

Mr. Mielke. We have letters that are attached to the testimony which document those dates of correspondence. The prepared testimony also has a chronology of events.

Senator Conrad. Can you give us right now when that first contact was?

Mr. Mielke. The first letter that we sent to Ferruzzi is May 16, 1989. We followed that up with a letter of May 18, 1989, and that is with respect to the May future. With respect to the July future, we were holding meetings and discussions with Ferruzzi in early June and again in early July in personal meetings. We had a number of telephone conversations.

Senator Conrad. Those were with respect to the July contract?

Mr. Mielke. July future.

Senator Conrad. All right.

Mr. Mielke. As soon as the May contract expired, we and the exchange turned our attention to July, and began immediate consultation.

Senator Conrad. What was the Ferruzzi position in terms of a percentage of what was on that market and the May contract? What was the percentage that Ferruzzi held at the time you made the first contact on May 16?

Mr. Mielke. I do not recall offhand. I am looking to see if it is in the letter.

I do not see the percent of open interest in the letter. The size of the position is shown in the letter. We can provide you that relative position——

Senator Conrad. What was the number of bushels?

Mr. Mielke. 16.2 million bushels.

Senator Conrad. 16.2 million?

Mr. Mielke. Yes.

Senator Harkin. Excuse me a second. 16.2 million bushels that you asked them to reduce?

Mr. Mielke. No, that was the size of position—there was that position so——

Senator Harkin. At what time and when?

Mr. Mielke. That was May 16, and it was with respect to the May future.

Senator Conrad. And they reduced that?

Mr. Mielke. Ultimately they did, yes.

Senator Conrad. And by how much did they reduce that position pursuant to your request?

Mr. Mielke. The answer to that question would be the position they had when the May contract expired. And I don't recall that exactly, but I believe it was less than 3 million bushels long, or approximately 3 million bushels long.

Senator Conrad. They went from 16 million bushels long to 3 million bushels long at the time of the expiration of the contract?

Mr. Mielke. That is my recollection. I would have to verify it.

Senator Conrad. What was the Ferruzzi position at the time you first contacted them with respect to the July contract?

Mr. Mielke. I am afraid my crib sheet does not go back into June.

It is my recollection that the position was greater than 25 million bushels long.

Senator CONRAD. Greater than 25 million bushels long when you first contacted them. And what was the date that you first contacted them about the July contract?

Mr. MIELKE. Let me quickly look to my chronology.

Mr. HINEMAN. While he is looking for that, Alan, would you just——

Mr. SEIFERT. I want to make a brief statement for the record about the report.

We submitted the report on the emergency action to the committee. That report includes, as an appendix, an attachment to it, the list from which I read previously about the Board member positions. And that report also in a redacted form; there are copies available in this room.

Mr. MIELKE. According to my chronology, we had telephone conversations with Ferruzzi representatives on May 25. And my associate advises me that their long position may have been over 30 million bushels in the July future during the early June period. We can verify that.

Senator CONRAD. The question that this all leads to is why the CFTC did not act earlier, given the position that you apparently were aware of that Ferruzzi had with respect to the July contract?

Mr. HINEMAN. Senator, again that is a judgment call that has to be made at some point in time.

I think, correctly, the Federal regulator, and also the self-regulator at the exchange level, want the market to work itself out if at all possible. That is better for everyone, obviously.

It was a judgment call at what time this stream ran out as to whether there was any possibility, given the fact that the long owned 60 percent of the soybeans in the delivery area, and that the long had a long position four times greater than the remaining beans in the delivery area which he did not own.

And at some point there, you know, those problems would have compounded, and they would become reality. The Commission decided to send that letter on the 7th, and the letter was actually sent on the 11th. So, then, in the decisionmaking, there was a little more time differential.

Senator CONRAD. You do understand the thrust of these questions?

Mr. HINEMAN. I understand.

Senator CONRAD. You do understand that there are some who assert that CFTC was aware in May of the May position, aware later but almost at the same time of a developing problem with respect to the July contract, a far more serious situation in terms of the long position of the group in question, and did not respond with sufficient speed and allow the situation to develop that then led to the result that we have before us?

And there is criticism directed at CFTC for not acting earlier with respect to the July contract. And that is really the question I am trying to get, why was there this waiting until you only had 7 days left?

Mr. HINEMAN. Again, you have a market going on every day. Every market day, every day of the week, there is a market going on and that market is doing things. And in this market, at that particular time, cash soybeans was dropping.

At that point in time, I think we would have been very seriously criticized if we had cut it off because then I think very legitimately people could say, well, the cash market had dropped from the futures, and you did not give us a chance to take soybeans to the delivery area.

So there are all kinds of problems of that kind, potential market disruptions, where too early a decision to take an emergency action would not be justified. It is a very close call, and one that takes experience to make. The CFTC market surveillance people did a close study of the availability of the beans and holders of long positions in the beans, and held talks with the principals involved to try to ascertain what they were going to do.

I think one of the harmful things was a letter from Ferruzzi, that the Chicago Board of Trade received along about that time. It certainly was not encouraging to anyone who wanted to wait past the date of the emergency action.

Senator **CONRAD**. Well, in the interest of making sure that my colleagues have a chance for their questioning, I will go to Senator Daschle.

Senator **DASCHLE**. Thank you, Mr. Chairman.

Mr. Hineman, has there been any study in the period since these decisions were made about who has benefited from the actions taken?

Mr. **HINEMAN**. We did look at those decisions in reviewing—I have heard it called study, investigation, and so forth—it is a review that we do by—it is required by the statute. It is a statutory mandate that we do these reviews.

Senator **DASCHLE**. So there is a statutory requirement?

Mr. **HINEMAN**. That is right, sir, statutory requirement.

Senator **DASCHLE**. Sort of an economic impact study of what decision was taken?

Mr. **HINEMAN**. Yes. This was a statutory requirement that we review these markets.

And with that, I will turn to Alan Seifert who headed up that effort.

Mr. **SEIFERT**. If I can clarify, Senator.

We did do a study of the emergency action, as we always do of emergency actions, and we have submitted that report.

Senator **DASCHLE**. Submitted it to whom?

Mr. **SEIFERT**. We have submitted a copy of the report with all confidential information that was submitted.

All the names are there with a code for some of the names that do not appear in the report.

Senator **DASCHLE**. When was this study submitted?

Mr. **SEIFERT**. It was submitted this morning.

Senator **DASCHLE**. This morning?

Mr. **SEIFERT**. This morning.

Senator **DASCHLE**. And when was it completed?

Mr. **SEIFERT**. It was completed within the time immediately preceding this morning. [Laughter.]

Senator **DASCHLE**. Would that be like last night? [Laughter.]

Without divulging some of the information, and I would certainly hope that we have a chance to read this report now that it is in our hands, it is safe to assume, I would imagine, that somebody has benefited substantially from that decision, whether it was inadvertent or advertent.

Mr. SEIFERT. I can answer your question from a certain aspect, and that is that within the scope of what we did in reviewing the emergency action, we followed our usual procedure of exploring whether there were any conflicts of interest on the part of the decisionmakers of the Board of the exchange——

Senator DASCHLE. And how did you determine that?

Mr. SEIFERT. The way we do that is that we gather all information that we can of two basic categories. One is information about the chronology of events, the details of events occurred, how meetings were scheduled, and who knew what when. We conduct interviews. And then the very important second part is that we conduct a review of trading in the relevant markets during the relevant time period to determine if there is in fact some improper activity, such that some individual, or firm is trading on nonpublic information, regardless of whether we think that there was actually an opportunity for that information to be available before it became public. Here, we do not think there was such an opportunity. Nonetheless, we went ahead and did a comprehensive review of the trading because if someone is attempting to profit, then they are going to attempt to profit on that information in the potentially impacted market of July soybeans.

So we did a review of the trading in the July soybeans and related market, and notwithstanding the broad nature of the trading analysis, we did not see trading by the individual members of the Board of Governors, by the BCC, their affiliated firm accounts, or by other market participants that would indicate to us that someone was in fact seeking to obtain a profit on nonpublic information.

Senator DASCHLE. Do you have the power to put those with whom you talk under oath as you investigate these circumstances?

Mr. SEIFERT. The Commission has the authority to put individuals under oath, yes.

Senator DASCHLE. Did you do that in this case?

Mr. SEIFERT. We did not. We did not put them under oath. We conducted interviews. As I said earlier, I think before you came in, Senator, the review of the trading confirmed all of the nontrading information that we had gotten. So I guess we could have done that. We did not do that.

Senator DASCHLE. Did you, as you came to any conclusion, were you able to categorize those who benefited from the decisions which were made, and the degree to which that benefit accrued, regardless of whether they advertently took actions which would have enhanced their position as a result?

Mr. SEIFERT. We did not conduct an economic analysis of the marketplace to determine whose positions went up in some manner, or went down in price in some manner attributable to the action.

Senator DASCHLE. Don't you think that is a fundamental question of an investigation of that kind, whether or not someone benefited and the degree to which they benefited?

Mr. SEIFERT. Well, we looked at it insofar as it would show trading to obtain such a benefit. But we did not look at every position in the market regardless of when it was put on.

For example——

Senator **Daschle**. Let me just stop you there for a second because I am monopolizing the time, and I apologize for that.

Again I am not pointing fingers, but I want to look and examine the way the CFTC functions under situations like this. And frankly I hear of the CFTC's involvement in something, I am less impressed and I am more skeptical about whether they can handle anything. And this seems to be another example of it.

I would think you would want to examine the categories of traders who held positions, the impact that this decision has had on them economically, regardless of whether they gained or lost. And the overall economic consequences that has had on the industry.

And what you are saying, I think, and correct me if I am wrong, is that you avoided gathering that specific information.

Mr. **Seifert**. Point of clarification, Senator.

We looked at activity during the period of July 3 through July 12, and we took that activity back to provide existing positions in June.

Our focus was the activity of individuals, all individuals in the marketplace, so that if someone was engaging in activity for the purpose of benefiting with respect to the subsequent emergency action, we could detect that.

What I was saying, and perhaps I did not make the point of distinction, is that we did look at all of the market participants. We looked at trading during the period of all of July preceding the emergency action, and took those positions back for certain accounts into the last week of June, in all instances taking positions back of the relevant players, the Board members, the BCC members, and their respective affiliated firms, so that we would have a complete picture of the chronology of those positions. When you have an opportunity to look at the report, you will see that there are appended to the report day-by-day bar graphs setting forth the change in those positions.

Now, we did not, however, focus on say a trader who had a July soybean position that was put on in May and was liquidated sometime in July, where there was no other reason to be concerned about the economic consequences that befell that position holder. We did not focus further on those positions because the issue that we were attempting to address was the relationship of the activity to the market emergency in terms of improper conduct and not just in a pure economic sense whether someone had a preexisting position on which a price change that may have been attributable to the market emergency might have impacted him economically.

Senator **Daschle**. As I understand it, you have not told me whether or not, by category, you have provided in your report an analysis of those who gained and those who lost by the decision you made.

You have told me that specifically you traced back some of the trading positions. But there is no collective study of the impact that this decision has had, positive or negative.

Mr. **Seifert**. We looked at the impact as to all trading in July soybeans and related markets during July.

Senator **Daschle**. I am talking about the post period, the time after the decision.

Is there an analysis of the impact that that decision has had, favorable or unfavorable, by category of traders in the week or two or three weeks succeeding the decision?

Mr. MIELKE. When you get an opportunity to look at the testimony and the attachments, we have provided a list of all the large positions in the market as of the close of business on the 11th. Those are the positions that conceivably could have profited from a fall in prices.

We also presented charts to show that the greatest fall in soybean prices occurred much after the emergency was over. But, nevertheless, if you look at those positions that were in the market on the 11th, there were no big short positions. The largest short positions were hedges against cash grain. There were no Board members holding those positions. There was only one short position with an affiliate of a Board member, and that again was hedge position against cash grain.

That information does not indicate that there was anybody in a big position to make a big profit from this emergency action should they have had advance knowledge of it or just been in a fortuitous circumstance.

Senator DASCHLE. Kalo, maybe you can tell us.

Was there any discussion as you analyzed what to do about the impact that your decision would have on producers, not traders but producers?

Mr. HINEMAN. My thoughts are forever on that point but in the broadest sense, taking into consideration what might have happened if we did not act, and what happens to producers from that chaos as compared to the other. That is what it is all about.

Senator DASCHLE. But was there discussion on it, not were you thinking about it, was there actual debate about the issue?

Mr. HINEMAN. Yes.

Senator DASCHLE. OK. And then the last question, and I am sorry I was late, and I understand that we have already discussed positions held by people on both the BCC and on the Board. But, just for future reference, as we consider regulation in the GAO report, do you think that it would be an appropriate rule to disallow anyone holding any position on a commodity upon which there must be a decision by that Board member during the time that decision is made?

Mr. HINEMAN. In this instance, John, we did not have anybody that had a position, and there is——

Senator DASCHLE. No positions?

Mr. HINEMAN. No. Didn't have a position.

Senator DASCHLE. What about the Board of Trade? I'm talking about affiliated or a craft.

Mr. HINEMAN. Affiliated firms, we did not have those that had——

Senator DASCHLE. You had no affiliated positions?

Mr. HINEMAN. We had some affiliated firms that had customer positions, and also some——

Senator DASCHLE. Well, that is what I am talking about. You had people with affiliated firms in customers positions so that is what I am talking about.

Mr. **Hineman**. But we checked to see if there was distance between them—in other words, if they have a public commodity side, then they are checked to see, even though it is owned by the same firm, was this person, did he have control, did he know what happened in the other division, or was he insulated from that?

And I understand exactly what you are saying, and that is a concern that I think constantly has to be checked.

Again it has to be weighed against having enough people that you can have the kind of people on those Boards that you need. And that is a judgment call.

I would be happy to——

Senator **Daschle**. Well, what is your judgment, that is what I am asking? What is your judgment on disallowing a vote for anyone who has a position or an affiliated position on a commodity during that time within it which a decision is made?

Mr. **Hineman**. Based upon this report at this time, where I saw no problem involved in doing it, at this time I would not be in favor of that, because I would wonder, and I am thinking about the Kansas City Board of Trade where you do not have all that many who would qualify with those restrictions.

On the larger exchanges, there are many people able to sit on those Boards. And the regulation fits all. So I would want——

Senator **Daschle**. You do not have qualified people to sit on the Board if you disallow that?

Mr. **Hineman**. No, I didn't.

Senator **Daschle**. I thought that was what you said.

Mr. **Hineman**. You do not have that many people without wheat positions at the Kansas City Board of Trade. Because that is the only really very active contract that they have now. And the same in Minneapolis.

Senator **Daschle**. What I think I hear you saying is that you cannot find qualified decisionmakers if you make that kind of a provision in regulation?

Mr. **Hineman**. I did not say that. I said I think it needs a lot of study before one arrives at that decision. I do not think it is a decision to be made without a lot of study to make sure of that—and in this instance it was not a problem.

Senator **Daschle**. You know, I suppose you can argue for study a lot, and we will be studying this.

Mr. **Hineman**. Well, I think it should be.

Senator **Daschle**. I tell you what. I think the perception is something we have to address. And the perception is that we have a lot of conflict of interest there. That is the perception. I hear it constantly. We talked about it yesterday. And it is pretty hard to separate perception from reality, frankly, when you have people holding positions, either affiliated or direct, and making decisions upon which they are going to be affected in some way.

I think that is one of the worst examples of the kind of conflict that has created this whole cynicism about your ability to regulate. And I think we have to deal with it very effectively.

Mr. **Hineman**. I can guarantee you that this will be looked at in depth and from lots of other angles.

Senator **Daschle**. Oh, we have looked at it a lot. We need something other than looking at it. You know, we need some action.

And I have to tell you, when it comes to things like this, looking at it just is not enough.

Mr. HINEMAN. In this case, it was not a problem.

Senator DASCHLE. Well, I will take your word for it.

Thank you, Mr. Chairman.

Senator HARKIN [presiding]. Thank you, Senator Daschle.

Well, I am just picking up a little bit where Senator Daschle left off.

We have a real problem here. And a lot of people are on the firing line. And I hope you understand you are on the firing line.

Mr. HINEMAN. Yes, sir.

Senator HARKIN. I do not mean you alone, I mean all of you. The CFTC is on the firing line.

And I will just lead off by asking a question. I have not heard it asked since I have been here. I apologize for being late.

But it has occurred to me and several others that somehow Ferruzzi got long, real long in May and in July.

Now, who gave Ferruzzi the exemption?

Mr. HINEMAN. We did.

Senator HARKIN. You did?

Mr. HINEMAN. CFTC, right.

Senator HARKIN. Now, that strikes me and a lot of others as very curious. You give Ferruzzi the exemption to go long.

Mr. HINEMAN. We gave them an exemption from speculative position limits.

Senator HARKIN. Which was what?

Mr. HINEMAN. It was an anticipatory hedge exemption.

Senator HARKIN. From what limit?

Mr. HINEMAN. Three million bushels.

Senator HARKIN. Three million.

Mr. HINEMAN. Yes.

Senator HARKIN. Up to 25 or 30 million?

Mr. HINEMAN. Up to whatever area—he had to do weekly reports to us as to his cash positions, and it has to be a justified hedging.

Senator HARKIN. Well, now, you see again, this is something that is not written about much in the paper and people do not understand.

You gave Ferruzzi the power and the ability to get that long in the market.

Mr. HINEMAN. Based upon legitimate hedging needs at that point in time.

Senator HARKIN. Then we get back to these points in time. Then there came a point in time where you said it was not legitimate. Why was it legitimate in May but not in June?

Mr. HINEMAN. The relative positions between cash and futures had changed in July. There was plenty of evidence that, for the reasons that Ferruzzi had stated that he wanted the anticipatory hedge, that he could satisfy that anticipatory need—or he could satisfy that need cheaper—in the cash market and at locations that fit the need better than the Chicago and Toledo locations.

All of the daily back and forth is to decide, is there still a verifiable need for those hedging exemptions? And that is a fluid thing. It changes. As the market changes and as Ferruzzi does various and sundry things.

Senator **Harkin**. But in the interest of an orderly market, on the 18th of May, you said that Ferruzzi had liquidated its May contract down to 3 million bushels, on May 18. Is that not correct?

Mr. **Mielke**. That is our recollection of the facts.

Mr. **Hineman**. Senator, I am going to turn you over to John Mielke for these questions.

Senator **Harkin**. On the same day, you knew, or you had already granted an exemption to Ferruzzi on the July contracts.

Mr. **Mielke**. Let me clarify the hedge exemption process under the Commodity Exchange Act.

The Commodity Exchange Act specifies that we must exempt bona fide hedge positions from speculative positions limits. That is not a discretionary process. We can challenge a hedge exemption if we believe it is not bona fide. We also have a basis of challenging the exemption if we believe it poses a threat to the orderly liquidation of the contract. But, largely, it is a self-effectuating process which is monitored as grain firms submit cash positions to us so we can assess the size of their cash positions relative to the size of their futures position.

For one type of hedge exemption, anticipated processing requirements, we require a specific application. They can file an application for their annual anticipated processing requirements.

What we did on July 11, 1989, was write a letter to Ferruzzi, and stated, "On the basis of our concerns for an orderly liquidation, we will not consider any positions you hold in the July future during its last 3 trading days as hedges of anticipated processing requirements."

What that meant was they had to hedge their anticipated processing requirements in another future. They had an August future available to them, a September future, a November future. They had to move their hedge out of that market so that they would not cause a disorderly liquidation of the July future.

Senator **Harkin**. But that meant that they had to liquidate those positions.

Mr. **Mielke**. They had to roll those positions forward or go into the cash market and buy soybeans, or both. They did not have to liquidate any position in terms of a total long position as long as it was justifiable, either by anticipated processing requirements, or fixed price export sales.

If they examined their books, they had the numbers to justify the gross positions. Our concern was those positions were posing a threat to the orderly liquidation of the contract, the Chicago Board of Trade——

Senator **Harkin**. What you meant is they could not get delivery—is that what you meant?

Mr. **Mielke**. There was a threat of a default, a squeeze, manipulation, price distortion, yes.

Senator **Harkin**. What you are saying is they could not take delivery?

Mr. **Mielke**. Correct.

Senator **Harkin**. OK. Let's just put it in plain good old English that everybody understands. They just could not take delivery.

How do you decide that their hedging needs were no longer good on that day? Why did you, all of a sudden on July 11, decide that when you had known since May how long they were in the July contracts?

Mr. **Mielke**. The surveillance process was one of continual communication and continual escalation of informal means to encourage a voluntary liquidation of the position that we saw posed a threat.

Senator **Harkin**. And did you ask Ferruzzi to voluntarily liquidate?

Mr. **Mielke**. Yes.

Senator **Harkin**. I heard that earlier. I wrote that down. You said you did, and you said what? You said they refused to liquidate?

Mr. **Mielke**. What happened was we looked at their positions after we asked them to liquidate in an orderly manner, and after the Board of Trade specifically told them certain numbers that were to be met on a daily basis. And the liquidation did not occur.

Senator **Harkin**. I thought you said Ferruzzi refused to liquidate.

Mr. **Mielke**. Well, they did not liquidate.

Senator **Harkin**. But I understand that from—let me check my notes again here—that from July 5 to July 11, Ferruzzi reduced its July futures by approximately 4½ million bushels.

Mr. **Mielke**. They were asked to reduce it 3 million bushels per day by the Chicago Board of Trade Business Conduct Committee on July 5. That was followed up by the very strong letter on July 7. That position was monitored daily on July 5, 6, 7, 10, and 11. And on no day did any liquidation occur anywhere near 3 million bushels per day.

Senator **Harkin**. That brings me to the next question.

You talked earlier about the short positions, and I was listening to what you said to Senator Daschle, you could not find anybody that was big in the short position. But, on July 10, how many bushels were short?

Mr. **Mielke**. Well, obviously, the total open interest is equal; one long equals one short. On July 10, what was the largest short position in the market, is that your question?

Senator **Harkin**. Not the largest. How many total bushels do you think we were short in the market at that time in soybeans?

Mr. **Mielke**. Well, the total open interest was about 40 million bushels, as I recall.

Senator **Harkin**. That is exactly the figure I have, 40 million bushels short on July 10.

How many traders held short positions?

Mr. **Mielke**. Approximately 11 traders held reportable short positions—I am basing this on the 11th because I——

Senator **Harkin**. I do not understand. What does that mean, reportable?

Mr. **Mielke**. We get data every day on the size of all large positions. For soybean futures, large means 500,000 bushels or more in any one delivery month. That is how we monitor the market, just the big people.

On this date, there were——

Senator **Harkin**. On July 10——

Mr. **Mielke**. I have the 11th in front of me. As I dig through my book, I might find the 10th as well.

But there were 11 people who held short positions greater than 500,000 bushels, the largest of which was 3.9 million bushels.

Senator HARKIN. The largest was 3 point——

Mr. MIELKE. That is on the 11th. I will see if I have——

Senator HARKIN. On July 11.

Mr. MIELKE. Yes.

Senator HARKIN. That would be the same on July 10 too?

Mr. MIELKE. The positions probably would have been a little bit bigger.

Senator HARKIN. On July 10?

Mr. MIELKE. Yes. Because we are seeing a steady liquidation of short positions. I do not have the complete enumeration of the 10th position so——

Senator HARKIN. I would like to know what the 10th positions were.

Mr. HINEMAN. We will get those for you.

Senator HARKIN. I would appreciate that.

[The requested information follows:]

REPORTABLE TRADERS IN JULY SOYBEAN FUTURE ON JULY 10, 1989

[In thousand bushels]

Trader	Type	Position	
		Long	Short
A	C, F	21,160	1,770
B	C	0	4,405
D	C, F	2,695	1,870
J	N	1,870	0
I	C, F	0	1,290
K	C, F	1,200	0
C	C	0	1,065
G	C	0	1,060
L	N, F	0	1,000
O	C	0	995
V	C	0	950
W	C, F	0	830
F	N	825	0
X	C, F	800	0
P	C, F	0	740
Q	C	500	695
M	C	0	680
S	N	615	0
T	C, F	580	0
U	C	0	545
X	N	510	0
Y	N	500	0
Z	N, F	0	500

Senator HARKIN. So 11 traders held short positions of more than 500,000 bushels, and the largest was 3.9 million bushels. Obviously, there could have been other traders less than 500,000 but you do not know about that.

Mr. MIELKE. There were because, at that point, about 58 percent of the short open interest was held by nonreportable small traders.

Senator HARKIN. So, 58 percent—let me write that down—58 percent of the shorts were nonreportable.

Mr. **Mielke**. Fifty-eight percent of the total open interest on the short side was held by small, nonreportable traders who are not in our system.

Senator **Harkin**. Well, held by traders who did not have to report because of the position they had.

Mr. **Mielke**. The position was too small.

Senator **Harkin**. It is not that they are not reportable traders, they may have to report on something else.

Fifty-eight percent of the shorts held by traders on that day were nonreportable shorts. Do you have any information about how many traders who held short positions, went to the Board and talked to them about taking action to liquidate?

Mr. **Mielke**. I do not have any information on that. We know several did. We do not know how many.

Senator **Harkin**. You know that several traders who held short positions went to the Board to ask them to force Ferruzzi to liquidate?

Mr. **Mielke**. No.

Senator **Harkin**. No?

Mr. **Mielke**. I said we know several traders went to the Board and some contacted us, expressing their concerns about the orderliness of the July liquidation.

Senator **Harkin**. About the orderliness or the fact that they would not be able to deliver?

Mr. **Mielke**. I can only talk about the communications that those traders had with us.

Senator **Harkin**. I'm talking about these being orderly liquidated. Again, I want to put this in English so that the general public can understand.

Mr. **Mielke**. It's that the market could not accommodate the demand for 20 million bushels. I don't know if people used those words, but that's what they were talking about.

Senator **Harkin**. Well, let's see if I can get it in a different kind of language here. Traders held short positions. They had to make good on those positions. Now, Ferruzzi had all the longs—well, they were 23 million bushels long. If I were a trader and if I were 1 million bushels short, but I couldn't get them anywhere and I couldn't deliver, then I would be concerned about the orderly marketing process. Am I stating it somewhat correctly?

Mr. **Mielke**. You may, yes.

Senator **Harkin**. That's basically correct. So I tell you, I sniff something here. I sniff a couple, three things.

One, that a bunch of traders have come up short. They can't get into the market to cover their shorts. Now, that's another way of saying that they can't make delivery.

Number two, they then use their position to go to the Board, and to you, to convince the Board to take this kind of action on July 11, or at some point to take this action to force Ferruzzi to liquidate, because that helps them in their short position.

You know, you told me that some traders went, but we don't know how many. Is that what you're telling me?

Mr. **Mielke**. I don't know how many traders complained to the Chicago Board of Trade. I could find out how many people contacted us. But I'd like to state categorically that any recommendations made by the Market Surveillance staff to the Commission with respect to the July soybean future were not based upon complaints that we received from shorts or anybody else. They were based upon our own determinations. And based upon my consultation with the staff of the Chicago Board of Trade, I would say the same is true there.

Mr. HINEMAN. I'd like to make a point of clarification. When we use the term "trader," that means everybody in the marketplace. At that point, if there's a farmer there, he's considered a trader, it means an individual who is using the market at that time, so that there's no misunderstanding of what it is.

Senator HARKIN. OK. Thank you very much. I appreciate that. Let me back up, then. Maybe I need a little clarification here, Mr. Hineman.

When you say 11 traders held short positions greater than 500,000 or more, how many of those were members of the Board?

Mr. HINEMAN. John, do you have that?

Senator HARKIN. Thank you. I meant to ask that. You're absolutely right.

Mr. HINEMAN. These things tend to take on a language of their own.

Senator HARKIN. I know. Sometimes cutting through it is pretty hard.

Mr. HINEMAN. I thank you for your patience with us.

Senator HARKIN. Well, thank you.

Mr. HINEMAN. But I think it's important to get these answers done right.

Senator HARKIN. Yes.

Mr. HINEMAN. And to avoid any errors, and if there's questions afterwards, why, we welcome them.

Senator HARKIN. I appreciate that.

Mr. MIELKE. All right. Let me try to answer your question, and this requires some verification, a check of Board memberships, because I'm not familiar with all of these firms. But it looks like five or six, the firms themselves, are members of the Chicago Board of Trade. And one firm had a representative on the board of directors. So if you mean on the board of directors, only one; members of the Exchange as a whole, it looks like five or six are Chicago Board of Trade members.

Senator HARKIN. OK. Let me get this straight. Of the 11 traders you told me about that had greater than 500,000, 5 or 6 of them were members of the Board.

Mr. MIELKE. Members of the Chicago Board of Trade.

Senator HARKIN. That's right.

Mr. MIELKE. There are 1,402 members of the Chicago Board of Trade.

Senator HARKIN. That's right, CBOT. And one of them had a member on the executive——

Mr. MIELKE. Member on the board of directors.

Senator HARKIN. On the board of directors.

Mr. MIELKE. An affiliate position.

Senator HARKIN. Can you tell me if that one that had a member on the board of directors was one of the largest ones?

Mr. MIELKE. No; they were not.

Senator Harkin. It was not the one 3.9 million bushels short.

Mr. Mielke. No.

Senator Harkin. But it was greater than 500,000?

Mr. Mielke. Yes.

Senator Harkin. Obviously. Obviously.

Well, again, you tell me that some of these traders contacted you?

Mr. Mielke. Yes.

Senator Harkin. About the, quote, "orderly marketing"?

Mr. Mielke. As did people who did not have a position in the market.

Mr. Hineman. If I might, that had been going on for some time. People had become concerned about this market because the price differentials weren't right, that it wasn't allowing for carrying charges and so forth. So, to that extent, when that happens, then it becomes not a useful tool for hedgers, and the concern was coming from hedgers.

Senator Harkin. OK. I want to get back to something else here. On July 11, now, I understand Ferruzzi had reduced its long position over a period of several days by 4.5 million bushels. Now, you correctly stated that the Board had asked them to reduce it by 3 million a day, I believe it was.

Mr. Mielke. Yes. At least.

Senator Harkin. They had only reduced it over about a week's period of time, I think the week's trading period of time, by 4 million or 4.5 million bushels.

Now, Ferruzzi claims, or at least the representatives claim, that they still had—how many days left after the 11th?

Mr. Mielke. Seven. Seven business days.

Senator Harkin. There would be 7 trading days left in the month to liquidate the contract.

Mr. Mielke. Yes.

Senator Harkin. And they said that for 20 million bushels, that 7 days would allow a large trading company such as Ferruzzi to orderly liquidate.

Mr. Hineman. If the beans were there.

Senator Harkin. Yes, if the beans are there. But I guess then that's what we come down to again, isn't it, if the beans were there? So we've come full circle.

Mr. Mielke. Senator——

Senator Harkin. Now, we've come—I'm sorry. Go ahead.

Mr. Mielke. Maybe I'm anticipating your question, and I apologize if I am. But what the Board of Trade and what we were looking for was a good-faith demonstration by trading that the liquidation would take place, and that signal was not coming back through the communication channels as of the 11th.

Senator Harkin. Well, again, I come full circle back. That's partially anticipating my question, but I'm coming back to where I started from. You granted Ferruzzi the exemption. You're tracking their longs. You've known about it since May. You've watched this develop. Then, all of a sudden, it seems to me that in a period of just a few days things start to happen. Traders contact you. We don't know, but I'd like to find out, did they contact the Board?

Mr. **Hineman**. But the contact by the traders was way earlier. This started way back last winter. Contact by shorts who were concerned about the market. I want to correct that. That wasn't something that happened, bang, just ahead of the emergency action.

Senator **Harkin**. Maybe a few did, but I'm just wondering how many. Did the pressure increase from these traders who were short?

Mr. **Hineman**. Not to me it didn't.

Senator **Harkin**. But to the Board of Trade?

Mr. **Hineman**. I don't know.

Senator **Harkin**. How do we know? Can we find that out?

Mr. **Hineman**. We will get you that information.

[The material subsequently supplied for the record can be found on pages 47–48 and 264–274.]

Senator **Harkin**. I'd like to know. I'd like to find that bit of information out.

Again, I still have the question; I just want to know why you waited so long. Why wasn't this done in the middle of June? You know, you look ahead and you say, well, now, wait a second. Ferruzzi has all these longs. We've granted them these exemptions. We'd better put them on notice, that they better start reducing their long position, especially if you've been contacted on this a long time before.

What's your response to that? I'm still wondering why you waited so long.

Mr. **Hineman**. If your assumption is that the market is functioning like it should be at that time, then the long hedgers would be put at a disadvantage. Somebody's going to get hurt whenever you take an emergency action. You know that. And it's the proper thing, and I think rightly, that you wait until you think that there is no possibility that it's going to work itself out—knowing the numbers and the lack of beans in the delivery area and the timeframe precluding shipping millions of bushels of beans into the area, that you finally have to come to grips with it. You know, that's D-Day. You have to do something. And you don't like to do it ahead of time because if the market can right itself, that's by far the best way. And it's worth waiting for as long as you can. That's the best answer that I have.

Senator **Harkin**. Why didn't you ask Ferruzzi to liquidate down to, say, 10 million bushels, 12 million bushels, 15 million bushels?

Mr. **Hineman**. It wouldn't have fit with the amount of beans that we had left; assuming that some others might have stayed in there, too. In other words, that wouldn't, in my opinion, have fit with orderly liquidation at that point.

Senator **Harkin**. How many beans were available at the delivery points around Chicago and—what's the other point?

Mr. **Hineman**. Toledo.

Senator **Harkin**. Toledo. I understood there were around 11 million bushels.

Mr. **Mielke**. There were a total of about 13 million bushels in the warehouses and about 8 million of that was already owned by Ferruzzi before we got to this point.

Senator **Harkin**. So in Toledo and Chicago, you're saying there were only 5 million bushels?

Mr. **Mielke**. That other people owned.

Senator **Harkin**. That was deliverable.

Mr. **Mielke**. That was deliverable.

Senator **Harkin**. As of July 10 or 11?

Mr. **Mielke**. Right.

Senator **Harkin**. But now we still have quite a few trading days to go in the July contract.

Mr. **Mielke**. And we assessed and the Chicago Board of Trade staff assessed, based on conversations with people in the cash market and based upon our experiences, what was moving. We were monitoring the daily receipts and shipments at the major markets, and we reached a conclusion that we would not see an augmentation of deliverable supply of any sizable proportions through the end of July. And we did not think we'd see an augmentation of—a maximum of——

Senator **Harkin**. If I'm a trader and I have 500,000 bushels and I'm short, I have to deliver.

Mr. **Mielke**. Or buy your position back.

Senator **Harkin**. Or buy the position back. So it would seem that the people with the shorts made out like bandits on this one. It seems like to me they just made out, boom. This is the marketplace. Sometimes you win, sometimes you lose. But it seems to me that somehow something intervened in here to make sure that the shorts didn't lose. And in the process—and I have to be very frank with you, maybe if it had been done in a more orderly fashion earlier on, we'd have been all right—but in the process, I have to tell you, my farmers got hurt, and I don't just mean to be parochial about this. I mean all farmers got hurt.

You look at what happened to those August soybean prices. I know some have said the price would have gone down anyway. No, no. What happened—and you know as well as I do the psychology of that—when they were forced to liquidate and those prices started to drop, every farmer out there and every little elevator system said, my gosh, I'd better get my beans in there now before it goes any lower. And that's what happened, a mad rush to deliver those soybeans, and you saw what happened to the market.

Now, farmers didn't have to sell those soybeans. They didn't have to. But up here they're thinking, wait a minute, they're watching that market go down every day. They're watching what happened in July, and they're saying I'd better get in there right now before I lose any more money. That just caused the market to go down even more.

So that's what I'm looking at. These were the losers. The farmers are the big losers out there. They lost a bundle of money. I haven't even calculated how much they have lost. And I'll tell you, I have to tell you, I hear it from farmers all over the State of Iowa and outside the State that they just think they were taken, really taken.

Now, I don't hear too many of the people with shorts complaining. They're not complaining. They're happy. Well, why should they complain? They took a gamble, too. Now, I'm not saying disrupt the whole market, but, again, my question is why not reduce the limit down to 15 million bushels. Well, maybe some of these people who were short would have had to scramble. Maybe they would have had to sell some of their positions. I don't know why that wasn't done. At least it would have helped the farmers out. At least that price wouldn't have dropped that precipitously.

I don't know if you have a response to that or not.

Mr. HINEMAN. I do have. It's the same one I've been giving, though. That is, you have to weigh that against the disorderly market, and how much does that cost farmers? And then you also have to ask yourself, how many soybeans were still out there for sale before we go projecting——

Senator HARKIN. Well, I have to tell you, some of——

Mr. HINEMAN [continuing]. The sales based upon what might have been sold at that period of time. And also I think the weather charts, you have to look at the charts and decide for yourself when did this happen. You know, I think there's an awful lot of things in this situation where judgment has to come into play, and somebody gets hurt on one side of the market regardless of which happens. And as you heard me say ahead of time, being a farmer, you know, I don't like to see these things happen to farmers. But we made a judgment call. I think it is far worse to have the integrity go out of the marketplace so that it is no longer useful for price-basing and for hedging for the processors, for my elevator who bids me, and for all others. That's a far worse thing than a swift, decisive emergency action, and I maintain that during that period of time, right after the emergency action, I think the charts say very clearly what really happened and how much influence there was from the weather.

You look at corn and look at soybeans and the close association between the two, and it's remarkable. Can I say that without any question whatever? I don't suppose any of the economists that come out from the universities to tell us about price trends and so forth can ever do that. But it looks like to me as if the charts are very revealing.

Senator HARKIN. Well, you can have disorderly markets with some people on one side and some on the other side. Now, again, from my farmers' standpoint, if some of these people holding those shorts had to go out and fill those contracts, the price would have gone up. The farmers would have made out a little bit better. I mean, they're holding soybeans—they're long. Farmers are long. They're holding the soybeans. They're all long, except for a few maybe that are trading.

Mr. HINEMAN. Yes, I think there could have been farmers that were hedged in July soybeans, and they're on the other side.

Senator HARKIN. There may have been a few, but most of them out there holding the soybeans are on the long side.

Again, if you're going to have a disorderly market, what I'm thinking about is how to have less of a disorderly market. Were there any alternatives that you could have used to achieve the integrity of the market that would have been less disruptive to the farmer than what happened?

Mr. HINEMAN. Nothing is going to be a higher priority in my mind for the rest of my time on this Commission than that, and to addressing the issues that are raised by the FBI investigations, I assure you. But when we go into the alternatives—my Agricultural Advisory Committee, which I chair, has representatives from all the major farm organizations, and also the processors and also not to forget those who we must have in agriculture, the lenders. We have representatives sit there from the Farm Credit System, from the American Bankers Association, and from the Independent Bankers Association. It covers the waterfront of agriculture and those who are affected so much by the pricing and integrity of marketplaces.

I had a meeting of that committee the 28th of August to go over these issues and plan to have another meeting soon. I tossed out an idea to them: Would you like to engage in some studies of delivery points and the processes relating to delivery points? I know from the proliferation of delivery points that we have in live cattle that when you get proliferation of delivery points, it also brings problems, unfortunately. Nothing's quite simple. And the problem that proliferation brings is that it's very imprecise as to what you're pricing; which one of those points are you pricing? And that makes it difficult for hedgers and makes the basis kind of swing all over the place.

One thing I know, the price will go to whichever is the cheapest market because the short has the call as to where they're going to deliver. We're seeing that now in the cattle contract, with the Peoria issue—and that's one of the big issues. People in other parts of the country say, well, that's always the cheapest price, and that's the tail, and it drags the market down.

So there's a lot of work that needs to be done, I think, by a lot of people. And the Chicago Board of Trade needs to face up to this. They need to review their delivery procedures. They need to make sure that it still sits in the mainstream of agricultural movements. One thing I know, and that is that in the export of soybeans, 80 percent of it goes out of New Orleans now.

Senator HARKIN. Goes out of where?

Mr. HINEMAN. Goes out of New Orleans. We need to look at those things, and when I say "we," I mean collectively, everybody that has an interest in it, and review not only the good points but the bad points. No one wants a better solution more than I. But when it finally comes down to it and there has to be a decisive action taken, I want it to view both sides of that marketplace and what it is they're doing to the people that are getting hurt.

You know, I hear you loud and clear when you're saying you have farmers who got hurt. I understand that, and I understand how traumatic that is. And I also understand that if government or somebody has anything to do with it, you know, nothing gets my ire up quicker. But, on the other hand, I want a marketplace that is reliable for price basing and that hedgers can use; because if hedgers can't use that market, I'm not going to have a very good market. The bid-ask spread is going to be very wide. They're going to bid wider and cheaper—that means cheaper to me as a producer—if they don't have a reliable place to hedge. And it will be the ability to hedge on these markets that also facilitates and helps exports, which to me is a most important part.

Senator HARKIN. I can't argue with anything you're saying. Obviously, I agree with the need for a good market. It's in the best interest of farmers. They must have that market out there, and a place also that they can hedge so that they can lock in a price for futures.

One other thing I want to ask is whether you're going to pay some close attention now to granting these exemptions. You say you have to grant exemptions. I was not aware of the fact that you have to grant exemptions. Again, people that I have talked to have said the CFTC grants the exemption that allows large long positions, and then they turn around and yank the rug out from under them and force them to liquidate and causes all these problems—that CFTC shouldn't have given the exemption in the first place.

Mr. HINEMAN. I think we need to examine that. Without that exemption, can they do the kind of hedging they need to do so that they narrow that bid-ask spread and give me the right price? Or do they have to go this way with it?

Senator HARKIN. I don't know. I don't know the answer to that.

Mr. HINEMAN. So that's the tradeoff, and that's the reason that it's there, to allow these people some methodology whereby they can get a hedge position, get positions that will fit their commercial needs so that they can hedge the risks.

Senator HARKIN. Is it unusual to give that much of an exemption—up to that many bushels? Up to 30 million bushels, I guess you gave them.

Mr. MIELKE. There are positions in the market larger than that. There are cash market needs much larger than that. And they have a right to hedge those needs in the futures market——

Senator HARKIN. In soybeans?

Mr. MIELKE. In soybeans.

Senator HARKIN. In soybeans.

Mr. MIELKE. And they have a right to hedge them until they abuse that right, and then there's a basis for taking an action to reduce their hedge privilege.

Senator HARKIN. Well, I guess we've been through it all. I don't mean to go around the horn again on this subject. I think I've gotten through basically what I wanted to get through.

Just to tell you about some of the things that people are telling me and asking me questions about, and what some of the farmers are asking about, they're asking: Why didn't they do something earlier in June? Make the liquidation over a longer period of time? I still don't know that I have the answer to that. I guess what you're telling me is that you wanted to give the market all of the room possible to work and to work itself out. And if it doesn't, then you step in.

You said you're going to take a look at what other alternatives maybe could have been followed at that time. I still don't know if I have an answer as to why you couldn't have just ordered liquidation down to 10 million or 12 million bushels rather than down to 3 million and then 1 million. You still don't feel that they could have delivered those beans?

Mr. MIELKE. No.

Senator HARKIN. It just seems to me that some time before that, if you're talking about the difference between 23 million bushels and 3 million bushels on—20 million bushels—then it would seem to me that 2 weeks before that, 3 weeks before that, you would have been seeing that start to develop, seen that you would have to do something. Maybe you wouldn't have seen a difference of 20 million bushels; maybe you would have just seen 10 million, 12 million. As the the days and weeks go by, that spread gets bigger and bigger.

Again, at some point, you knew how many beans there were to deliver. If you knew that Ferruzzi owned 8 million bushels of soybeans in Toledo and Chicago and there were only 5 million more bushels there, you must have known that a couple weeks before that. So if there's only 5 million to deliver there, and they're 30 million long, and you see that early in June, I would have thought little red flags would be popping up around the place.

Mr. HINEMAN. They were, and we were jawboning very vociferously and trying to get pledges for them to start reduction. We got none.

Senator HARKIN. You started back in June telling them to do that?

Mr. HINEMAN. Yes.

Senator HARKIN. So you don't think there was any alternative thing you could have done?

Mr. HINEMAN. The alternative we took, in my best judgment, was the right one at the right time. It's easy to second guess in retrospect, and are there other alternatives that could have been done? I suppose there are. But, again, in retrospect, looking at what it did, it accomplished what it was supposed to do; that is, it avoided a severe market disruption.

I know to those who were involved and had beans at that time, one day's disruption is too long. But I think the total disruption would be worse.

Senator HARKIN. Something new has come to me here. I don't mean to go on and on. A member of the staff just told me that on the 10th—this is your prepared testimony here—you gave alternatives.

Mr. HINEMAN. We were asked by the Chicago Board of Trade, and we gave——

Senator HARKIN. You gave the Board of Trade five alternatives.

Mr. HINEMAN. They asked us what we thought were the various things they might do. We recited them to them.

Senator HARKIN. Five alternatives.

Mr. HINEMAN. Yes.

Senator HARKIN. That's in appendix 9 of your prepared testimony, Kalo.

Mr. MIELKE. Yes.

Senator HARKIN. So you gave them five alternatives.

Mr. HINEMAN. Yes, I guess you could call them alternatives. But we gave them—they asked us for whatever various and sundry things that you think from your standpoint as an expert regulator, what are the different things that could be done, not rating them by what we thought good, bad, poor, whatever.

Senator HARKIN. So you gave them five, and they took No. 1, I see.

Mr. HINEMAN. They took a form of No. 1, yes.

Senator HARKIN. But if they had taken No. 2—I'm just reading this—"Require a daily proportionate decrease of all positions, excepting new sales for delivery evidenced by grain in-hand. For example, all accounts must reduce by (90 percent divided by 7 equals) 13 percent . . ." [3] What if they had taken No. 2? That would have been a little bit more orderly, wouldn't it have been?

Mr. **Hineman**. Again, that's a judgment call. I happen to think they took the right one.

Senator **Harkin**. No. 1?

Mr. **Hineman**. Well, it's a variation of No. 1.

Senator **Harkin**. Well, they revoked the hedge exemption to require reduction to a limit of 3 million bushels. That's what they did.

Mr. **Hineman**. It's basically No. 1.

They weren't really revoking hedge exemptions, were they, John? They were just saying reduce?

Mr. **Mielke**. They required the reduction to apply to all traders.

Mr. **Hineman**. All traders.

Mr. **Mielke**. Regardless of whether or not they were hedgers.

Senator **Harkin**. Yes.

Mr. **Mielke**. So it's the same effect.

Mr. **Hineman**. Then just said to everybody, reduce by 20 percent per day over the next 5 days, and then the last 2 days you have to reduce until you get down to 1 million bushels. Shorts and longs.

Senator **Harkin**. Yes.

Mr. **Hineman**. I think there's some justification for that. It put some responsibility on the shorts to meet them. And there's some good points in every one of the five alternatives. But at this point, I think it was the CBT's call.

Senator **Harkin**. Well, I just don't think it was right. That's where you and I part a little company there, Kalo, because as I looked at these, I thought there could have been some alternatives or combinations of alternatives. A combination of 2 and 5 perhaps. How about using No. 5? That sounds like something that could have been worked with No. 2 that might have been a little bit more orderly and wouldn't have let all the shorts off the hook.

Mr. **Hineman**. You and I will probably hear that for years, a discussion of which is the better.

Senator **Harkin**. I suppose that's true.

Mr. **Hineman**. Mr. Chairman, before we adjourn, I'd like to ask that the long testimony of the CFTC be admitted to the record.

Senator **Harkin**. Yes, without objection. And also I want to say I have an opening statement that I wanted to make as a part of the record at the appropriate place. Without objection, that will be entered.[4]

Well, thank you very much for being here and being so patient. I appreciate your answers. As I said, this has been a very crucial year for the markets and for the CFTC. I still wind up where I started. I think that the Board of Trade is on the firing line and I think you're on the firing line, and I don't think we've heard the last of this one yet.

Mr. **Hineman**. Thank you, Mr. Chairman, for asking, and I can tell you we aim to be up to the challenge.

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[3] Appendix 9, Emergency Alternatives Provided to the Chicago Board of Trade, see prepared testimony of Kalo A. Hineman, Commissioner, Commodity Futures Trading Commission.

[4] The prepared statement of Senator Harkin can be found on page 2.

Senator **Harkin**. Thank you, Mr. Hineman. Thank you all very much.

[The prepared statement of Kalo A. Hineman appears at the conclusion of the hearing.]

[Whereupon, at 1 p.m., the committee was adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

GAO

United States General Accounting Office

Testimony

For Release
On Delivery
10:00 a.m. EDT
Friday
September 8,
1989

Strengthening Trade Practice Oversight

Statement of
Richard L. Fogel, Assistant Comptroller General
General Government Programs

Before the
Committee on Agriculture, Nutrition and Forestry
United States Senate

GAO/T-GGD-89-39

GAO Form 160 (12/87)

FUTURES MARKETS: STRENGTHENING TRADE PRACTICE OVERSIGHT

SUMMARY OF STATEMENT BY
RICHARD L. FOGEL
ASSISTANT COMPTROLLER GENERAL
GENERAL GOVERNMENT PROGRAMS

In response to a request from the Honorable Patrick J. Leahy, Chairman, and Richard G. Lugar, Ranking Minority Member, Committee on Agriculture, Nutrition and Forestry, GAO answered a number of questions on the adequacy of oversight controls, the number and nature of disciplinary actions, the effects of high technology systems, and the use of management information relating to the nation's futures markets.

In summary, GAO is recommending that the Commodity Futures Trading Commission (CFTC) do the following:

1) Direct the exchanges to independently, precisely, and completely time each trade made on the exchanges and specify a time frame for meeting this requirement. This should significantly reduce the opportunity to commit trading violations and avoid detection.

2) Assess the merits and risks of using automated systems through use of its own resources or those of others, including independent contractors. This will help ensure that the exchanges maximize their potential to control trade practice abuses and provide correct transaction processing, responsive operations, and secure and continuous service.

3) Require complete documentation of existing and upgraded automated surveillance systems and independent tests of these systems. This should better ensure that the exchanges' surveillance programs operate as intended.

4) Establish milestones for completing definitions of trade practice violations and investigations, as well as begin making formal trend and comparative analyses of consistently defined investigations and disciplinary actions. This should help CFTC highlight issues for review; show the relative effectiveness of exchange approaches to detecting, investigating, and punishing abuses; and identify aspects of successful programs that all exchanges could adopt.

GAO issued two reports yesterday that discuss these recommendations--Futures Markets: Strengthening Trade Practice Oversight (GAO/GGD-89-120, Sept. 7, 1989) and Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss our views on how the Commodity Futures Trading Commission (CFTC) and the exchanges it regulates can better deter, detect, and punish floor trade practice abusers in the futures markets. At your request, we have followed up on our February appearance before this Committee and explored several questions you raised about the adequacy of oversight controls, the number and nature of disciplinary actions taken, the effects of high technology trading systems, and the use of oversight information. Our results are contained in two reports that we issued yesterday.[1] To do the work, we visited the Chicago Board of Trade (CBT), the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange (NYMEX), and the Commodity Exchange Inc. I would like to summarize our results in my testimony.

Recent allegations about the trading activities of certain futures market participants raise important questions about the integrity of these markets and about the quality of federal and self-regulatory oversight. In August 1989, the Department of Justice, as a result of Federal Bureau of Investigation (FBI) undercover operations, indicted 46 floor participants at the CBT and CME for engaging in trade practice abuses. These abuses which allegedly involved various schemes to enrich floor participants, violated the Commodity Exchange Act, CFTC regulations, and exchange rules.

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[1] Futures Markets: Strengthening Trade Practice Oversight (GAO/GGD-89-120, Sept. 7, 1989) and Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

INDEPENDENTLY, PRECISELY, AND COMPLETELY TIMING TRADES

Our work also has shown that dishonest floor participants, working alone or with a third party, can eliminate the risk of unfavorable market movements. They can manipulate the information on their trading records to give noncompetitive trades the false appearance of having been competitively executed at an earlier time when prices were more favorable to them. These practices could be deterred or more easily detected through independent, precise, and complete timing of trades.

Independent timing could prevent floor participants from using their knowledge of the market price in the immediate past to alter trading records and conceal execution of trades at noncompetitive prices. Precise timing could be used to determine the exact sequencing of each floor participant's trades, thereby making it easier to detect abuses. Complete timing, including the times the floor participant receives and executes the trade, could help reconstruct the history of each trade, not only to detect potential abuses, but also to prove that they occurred.

Exchange trading systems generally do not independently, precisely, and completely time all trades to sequence trading activity. Instead, exchanges attempt to reconstruct the sequence of trades using times that may be based on inaccurate or incomplete information. The timing information used to reconstruct the sequence of trades is part of the "audit trail," which is the documentation for all trades.

Audit trail information is obtained somewhat differently at each exchange, and different weaknesses exist in the audit trails of each exchange. However, the audit trail systems of three of the four exchanges we visited include some timing information provided by floor participants, such as trade time and sequence information. These systems, therefore, depend on the participants to submit accurate and complete timing information. The fourth exchange's system records times independently. But like the other systems, it does not record times precisely or completely. Therefore, it has difficulty sequencing trades, especially in active markets. In each system, opportunities exist to manipulate the timing and, therefore, the sequencing of trades.

CFTC requires each exchange to prepare a trade register that shows, for each cleared or matched trade, the execution time to the nearest minute. CFTC allowed the exchanges to develop individual audit trail systems to meet this 1-minute timing standard and required that the exchanges be able to report on the accuracy of the information. Three of the four exchanges report that between 84 and 90 percent of trade times can be verified as meeting the 1-minute timing standard. CFTC officials told us that CBT does not have a system for reporting on the accuracy of its trade times.

To the extent that audit trail information from floor participants is used to meet the 1-minute timing standard and reach the reported verification rates, neither the times nor their verification rates may be reliable. Even if the 1-minute times were reliable, they are not precise enough to always allow for complete sequencing of each floor participant's trades because many trades can occur within a 1-minute period. Finally, none of the exchanges precisely times when floor participants receive or execute customer orders. This time could help establish when the participants assume responsibility for promptly and competitively executing the orders.

CFTC proposed rule amendments in August 1989, tightening controls over the preparation and the submission of trading cards and submission of customer order tickets that will improve timing information and trade sequencing. The rules could go into effect in early 1990, and the exchanges have already begun implementing some of these changes as well as others. While these changes are important interim measures, floor participants will still be relied on to provide accurate trading records, and trade times will not be exact and complete.

In addition to the steps CFTC and the exchanges are taking to improve their existing system of controls, all four exchanges are exploring applications of new technology and automated systems that could provide more independent, precise, and complete trade timing. CBT and CME are studying and developing automated order routing systems to increase the efficiency of the futures trading process. All four exchanges are developing electronic audit trail systems to record transactions using hand-held terminals. CME, CBT, and NYMEX are also developing trading systems that will replace the current trading process to expand operations outside normal trading hours. These systems are still in the planning or development stage, and the extent that the exchanges will take advantage of the technology to control trading abuses is uncertain.

If properly implemented, these systems may lead to the independent, precise, and complete timing of trades necessary to better deter and detect trading abuses. Because many systems are just beginning to be developed, the time frame for achieving these goals is likely to be more than a year. Thus, CFTC and exchange proposals to tighten controls over trade practice abuses in current systems should be implemented quickly to provide needed interim improvements.

A lot of attention has been directed to the effect of dual trading on market integrity. Dual trading allows floor participants to trade for their personal accounts and those of customers on the same day. Market professionals generally agree that dual trading has several benefits, including increasing market liquidity. However, dual traders have the opportunity to trade ahead of customer orders and profit by making a series of trades and allocating the most favorable ones to their personal accounts and the least favorable ones to customers' accounts. This opportunity raises concerns about the extent to which dual traders are cheating customers and has led to proposals to restrict dual trading.

Restricting dual trading would not prevent floor brokers from using a third party to indirectly trade ahead of customers. In fact, the Justice Department indictments allege that some brokers were using third parties in an attempt to mask illegal trades. Trading ahead abuses could more easily be detected if trade times were independent, precise, and complete because the exact sequence and price of each floor participant's trades could be readily determined, as could the time when the floor broker received the order. Therefore, restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations.

ASSESSING AUTOMATED SYSTEMS

Although the exchanges' planned automated systems have the potential to better control trading abuses through independent, precise, and complete trade timing, they introduce risks that must be addressed to ensure correct transaction processing, responsive operations, and secure and continuous service. The exchanges are aware of these risks and are taking steps to mitigate them.

However, CFTC has not been actively involved in technical assessments of these systems' capabilities to control trading abuses and automation risks. CFTC needs to provide the necessary expertise to ensure that the systems currently planned by the exchanges maximize their potential to control trade practice abuses. It also needs to assess the risks of using automated systems. To accomplish these goals, CFTC could allocate its own resources, establish a technical advisory committee, and/or require the exchanges to have independent assessments performed on their systems under CFTC guidelines.

IMPROVING AUTOMATED SURVEILLANCE

Trade practice abuses can be detected by various means, such as manual review of the trade register, surveillance of the trading floor, and complaints from members. In addition, at different times over the last 4 years, the exchanges began using automated trade surveillance systems to review all trading activity and to provide investigators with exception reports that highlight suspicious trading activity. These systems can screen large volumes of trading data for potential abuses more efficiently than can manual methods. However, as we have discussed, the audit trail data upon which these systems rely is too imprecise for screening programs to accurately identify all potential abuses, and some of the systems are still in the early stages of development.

CFTC reviews the parameters and output of screening programs to determine the appropriateness of the leads the programs generate. However, CFTC does not review system documentation or test screening programs to determine whether the surveillance systems are operating as intended. In addition, CFTC does not require that the systems be independently assessed. Exchange officials told us that complete documentation has not always been available to describe initial system design, any subsequent modifications, and test results of those modifications. Such documentation is needed to determine whether the systems are operating as intended. A CFTC or other independent test of screening programs could include running data containing known violations through the exchanges' systems. Our recommendations are designed to improve the oversight of exchanges' automated surveillance systems.

USING MANAGEMENT INFORMATION

CFTC uses investigatory and disciplinary action information to judge specific exchange decisions and to monitor exchange progress from one rule enforcement review to another. It cannot use this information to formally analyze trends and compare results among exchanges because no uniform definitions exist for classifying the investigations and disciplinary actions involving floor trade practice abuses.

Such analyses and comparisons could help CFTC identify patterns in exchange oversight results that might highlight issues for review; show the relative effectiveness of different exchange approaches to detecting, investigating, and punishing abusers; and identify aspects of successful programs that all exchanges could adopt. For example, by tracking and comparing the exchanges' performance, CFTC could determine those detection methods that generate the most leads and could direct other exchanges to incorporate those methods, as appropriate. CFTC and the exchanges are beginning to develop uniform definitions. Our recommendations are designed to ensure their rapid completion and to encourage CFTC to better use the resulting improved disciplinary and investigatory information in its oversight.

ASSESSING DISCIPLINARY ACTION PROGRAMS

The number and severity of disciplinary actions that the exchanges have taken varies by exchange, but has generally increased as shown in the attached charts. From January 1, 1984, through June 30, 1989, the total number of floor participants penalized at each exchange ranged from a low of 17 at NYMEX to a high of 177 at CME; total fines ranged from about $300,000 at NYMEX to about $4.5 million at CME; and total suspensions ranged from about 300 business days at NYMEX to about 14,000 business days at CME.

We were unable to evaluate the significance of the differences in exchange disciplinary actions because the universe of abuses is unknown and the uniqueness and complexity of each case preclude an assessment of the adequacy and consistency of penalties. Moreover, the results of our comparisons of futures and securities market disciplinary actions were not useful because of differences in the types of abuses that occur in the two markets.

CFTC and exchange officials said that they are concerned about perceptions of potential conflicts of interest and about the fairness and consistency of the disciplinary action process. As a result, CFTC has issued proposed rules governing the eligibility of members with prior disciplinary histories to serve on disciplinary action committees. Also, the exchanges are considering actions, and in some cases have taken actions, that they believe will improve perceptions about the fairness and consistency of disciplinary action programs, including changing the composition of disciplinary committees and establishing minimum penalty guidelines.

SUMMARY AND CONCLUSIONS

In summary, CFTC and exchange officials had been working before the FBI investigations to improve the framework of controls over floor trade practice abuses. They intensified their efforts after news of the investigations became public, and have proposed or taken a series of actions, such as requiring more frequent collection of trading cards, that will improve existing exchange internal controls.

These actions are important interim measures for reducing the opportunity for dishonest floor participants to commit trading violations. However, CFTC and the exchanges must do more. While detecting every abuse may never be possible, CFTC and the exchanges need to take actions that will upgrade the overall character of market oversight and substantially reduce the opportunity to manipulate trading.

Foremost among the actions needed is improved timing of all trades. Most of the types of abuses alleged in the Justice Department indictments could have been more readily detected and documented with independent, precise, and complete timing of trades. For this reason, we are recommending that CFTC require the exchanges to go beyond upgrading existing internal controls and implement systems to independently, precisely, and completely time all trades.

We are also recommending that CFTC enhance its capability to evaluate the risks and technical configuration of emerging automated systems, expand its review of exchange automated surveillance systems, and improve its use of management information. We have not been able to reach conclusions about the adequacy of CFTC or exchange disciplinary action programs, primarily because the universe of abuses is unknown. However, the increased number and severity of penalties for floor trade practice abuses since the FBI investigation became public appears to indicate an increased commitment by the exchanges to deterring, detecting, and punishing trade practice abusers.

I want to make a final point. It has been known for some time that the potential for trading abuses on the futures exchanges is high. CFTC's recent proposals to better control trading abuses are, as I indicated, useful interim measures. But, they do not go far enough. We believe it essential that CFTC become more proactive in overseeing trading practices.

The alleged abuses in the Department of Justice indictments and the growing importance of the futures markets in our economy make it essential that the operating standards of market participants be upgraded. CFTC needs to lead the effort to accomplish the needed improvements.

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Mr. Chairman, this concludes my prepared statement. We will be pleased to answer questions.

GAO Futures Floor Trade Practice Disciplinary Actions

The Chicago Board of Trade	1984	1985	1986	1987	1988	1989	Total
Floor participants penalized	2	7	14	16	13	12	64
Fines (thousands of dollars)	30	260	156	162	180	1,196	1,984
Suspensions (business days)	819	381	1,012	2,222	6,104	20	10,558
Permanent bar	0	4	2	0	0	2	8
The Chicago Mercantile Exchange							
Floor participants penalized	4	33	27	38	51	24	177
Fines (thousands of dollars)	10	291	190	1,684	558	1,739	4,472
Suspensions (business days)	132	160	58	8,553	3,797	862	13,562
Permanent bar	0	0	0	4	1	2	7

Note: Data cover actions from January 1, 1984, through June 30, 1989.

Source: GAO prepared the table from exchange disciplinary action notices.

GAO

Futures Floor Trade Practice Disciplinary Actions

The New York Mercantile Exchange	1984	1985	1986	1987	1988	1989	Total
Floor participants penalized	6	1	5	0	2	3	17
Fines (thousands of dollars)	134	0	128	0	13	48	323
Suspensions (business days)	0	0	199	0	0	105	304
Permanent bar	1	1	0	0	0	0	2

The Commodity Exchange, Inc.							
Floor participants penalized	5	9	22	27	27	18	108
Fines (thousands of dollars)	248	368	421	640	613	375	2,664
Suspensions (business days)	0	147	283	707	411	242	1,790
Permanent bar	0	1	0	0	0	0	1

Note: Data cover actions from January 1, 1984, through June 30, 1989.

Source: GAO prepared the table from exchange disciplinary action notices.

United States General Accounting Office

GAO

Report to the Chairman and the Ranking
Minority Member, Committee on Agriculture,
Nutrition, and Forestry, United States Senate

September 1989

FUTURES MARKETS

Strengthening Trade Practice Oversight

Printed copies of this document will be available shortly.

GAO/GGD-89-120

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United States
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September 7, 1989

The Honorable Patrick J. Leahy, Chairman
The Honorable Richard G. Lugar, Ranking
  Minority Member
Committee on Agriculture,
  Nutrition, and Forestry
United States Senate

On February 23, 1989, we testified before the Committee on the effectiveness of the Commodity Futures Trading Commission (CFTC) and the exchanges it regulates in controlling trade practice abuses.[1] As a follow-up to that testimony, on March 27, 1989, you requested answers to a number of questions on the adequacy of oversight controls, the number and nature of disciplinary actions taken, the effects of high technology trading systems, and the use of management information. You also asked that, where possible, we compare controls in the futures markets with those in the securities markets.

This report provides our responses to your questions in appendixes I through XII, as well as our overall conclusions and recommendations. Some of your questions were on the potential impact of advances in information technology. Our answers to these questions are summarized in this report and provided in detail in a separate report.[2]

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[1] Commodity Futures Trading Commission and the Chicago Futures Exchanges' Detection of Trade Practice Abuses (GAO/T-GGD-89-8, Feb. 23, 1989). Also, see our report entitled Chicago Futures Market: Initial Observations on Trade Practice Abuses (GAO/GGD-89-58, Mar. 13, 1989).

[2] Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

BACKGROUND

Futures exchanges are centralized auction markets where standardized contracts, specifying quantity and quality, are bought and sold for future delivery. These markets provide protection against adverse changes in the cash price of an underlying product or financial instrument, such as wheat or Treasury bonds. They provide protection by transferring the risk of price fluctuations to those willing to speculate on those fluctuations in return for a potential profit.

Futures contracts are traded through a competitive system called "open-outcry," in which floor participants verbally make bids and offers to each other at centralized exchange locations, called "trading pits." Two types of floor participants execute trades in these pits--floor brokers and floor traders. Floor brokers trade for customers and may also trade for themselves. In contrast, floor traders deal only for their personal accounts. The futures markets are primarily self-regulated by the exchanges, with CFTC providing federal oversight.

January 1989 news accounts revealed the existence of joint Department of Justice and CFTC undercover operations at the Chicago Board of Trade (CBT) and at the Chicago Mercantile Exchange (CME). In August 1989, the Department of Justice indicted 46 floor participants--several of whom have pleaded guilty--for allegedly engaging in multiple floor trade practice abuses. The indictments raised questions about market regulators' effectiveness in deterring, detecting, and punishing floor trade practice abusers.

The August 1989 indictments indicate that the Federal Bureau of Investigation (FBI) found the same types of alleged abuses occurring in the CBT soybean and U.S. Treasury bond trading pits and in the CME Japanese yen and Swiss franc trading pits. The alleged abuses involved schemes to enrich floor participants in violation of the Commodity Exchange Act, CFTC regulations, and exchange rules. The glossary describes various abuses that can occur in the futures markets and that the Justice Department indictments allege occurred at CBT and CME.

Before the FBI investigations, CFTC and exchange officials had been working to improve the framework of controls over floor trade practice abuses. CFTC and exchange officials intensified these efforts after news of the investigations became public and have proposed or taken a series of actions that will provide incremental improvements to existing exchange internal controls.

RESULTS IN BRIEF

Weaknesses in controls over futures trading provide dishonest floor participants with the opportunity to cheat customers by noncompetitively executing orders and to conceal this cheating by manipulating the recorded price and time of trades. The actions CFTC and the exchanges have proposed or taken are important interim measures for reducing the opportunity for dishonest floor participants to commit trading violations. While detecting every abuse may never be possible, most of the types of abuses alleged in the Justice Department indictments could also have been detected and documented with independent, precise, and complete timing of trades. CFTC needs to require that the exchanges achieve this result. To the extent that trade timing and, therefore, sequencing remain imprecise, surveillance systems that use this information will have limited ability to detect trading rule violators.

In addition to requiring improved timing information, CFTC needs to expand its review of exchange automated surveillance systems and to improve its use of management information. We were unable to reach conclusions about the adequacy or effectiveness of CFTC or exchange disciplinary action programs, primarily because the universe of abuses is unknown. However, the increased number and severity of penalties for floor trade practice abuses since the FBI investigation became public appears to indicate an increased commitment by the exchanges to deterring, detecting, and punishing trade practice abusers.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our work were to answer the questions the Committee raised, primarily by assessing the effectiveness of CFTC and the futures exchanges in deterring, detecting, and punishing trade practice abusers. Our discussion is limited to trade practice abuses that occur when orders are not openly offered to all market participants on the exchange floor.

To meet our objectives, we interviewed officials and reviewed policies and procedures at the CFTC headquarters in Washington, D.C.; at the eastern regional office in New York City; and at the central regional office in Chicago. We also interviewed officials and collected data at the two largest Chicago futures exchanges, CME and CBT, and at the two largest New York futures exchanges, the New York Mercantile Exchange (NYMEX) and the Commodity Exchange, Inc. (COMEX). These four exchanges accounted for 93 percent of the futures contracts traded in the United States during 1988.

To compare futures markets with securities markets as the Committee requested, we interviewed officials; reviewed policies and procedures; and collected data at the Securities and Exchange Commission (SEC) headquarters in Washington, D.C. We also visited the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex) in New York City; the Chicago Board Options Exchange (CBOE) in Chicago; and the National Association of Securities Dealers (NASD) in Washington, D.C.

The disciplinary action data cover the period from January 1, 1984, through June 30, 1989. Our review of detailed investigative and disciplinary case files covered calendar years 1987 and 1988. We did our review from March 1989 through August 1989 in accordance with generally accepted government auditing standards.

INDEPENDENTLY, PRECISELY, AND COMPLETELY TIMING TRADES

Futures exchanges generally do not independently, precisely, and completely time all trades. Independent timing of trades could prevent floor participants from using their knowledge of the market price in the immediate past to alter trading records and to conceal execution of trades at noncompetitive prices. Precise timing could be used to determine the exact sequencing of each floor participant's trades, thereby making it easier to detect abusers. Complete timing of trades, including the times the floor participant receives and executes the trade, could help reconstruct the history of each trade, not only to detect potential abuses, but also to prove that they occurred.

Currently, dishonest floor participants, working alone or with a third party, can eliminate the risk of unfavorable market movements. They can manipulate the information on their trading records to give noncompetitive trades the false appearance of having been competitively executed at an earlier time when prices were more favorable to them. These practices could be deterred or more easily detected through improved timing of trades.

Exchanges attempt to reconstruct the sequence of trades using times that may be based on inaccurate or incomplete information. The reconstructed sequence of trades and the timing information used to determine the sequence are then used along with an exchange record of the times of price changes to detect and investigate floor trade practice abuses. The timing information used to reconstruct the sequence of trades is part of the "audit trail," which is the documentation for all trades.

Audit trail information is obtained somewhat differently at each exchange, and different weaknesses exist in the audit trails of each exchange. (See app. I.) However, the audit trail systems of three of the four exchange we visited include some timing information provided by floor participants, such as trade time and sequence information. These systems, therefore, depend on the participants to submit accurate and complete timing information. The fourth exchange's system records times independently. But like the other systems, it does not record times precisely or completely. Therefore, it has difficulty sequencing trades, especially in active markets. In each system, opportunities exist to manipulate the timing and, therefore, the subsequent sequencing of trades.

CFTC requires each exchange to prepare a trade register that shows, for each cleared or matched trade, the execution time to the nearest minute. CFTC allowed the exchanges to develop individual audit trail systems to meet this 1-minute timing standard and required that the exchanges be able to report on the accuracy of the information. Three of the four exchanges report that between 84 and 90 percent of trade times can be verified as meeting the 1-minute timing standard. CFTC officials told us that CBT does not have a system for reporting on the accuracy of its trade times. However, reported verification rates at the other three exchanges may not be reliable because floor participants can manipulate timing information to make illegal trades appear to have been executed competitively--that is, at prices that existed at an earlier time.

The ability of the exchanges to deter, detect, and investigate abuses is reduced by using audit trail systems that include information that is subject to manipulation, not precise enough to accurately sequence trades, or not complete enough to prove an abuse occurred. When floor participants record trade time and sequence information, opportunities exist to execute trades noncompetitively without detection. Because trading cards are currently required to be collected every 30 minutes, or even less often, sufficient time exists for participants to alter trading records to conceal abuses.

Further, while CFTC requires exchanges to report trading times to the nearest minute, a single minute during certain trading periods in an active market may include hundreds of trades. Because a single floor participant could have executed a number of these trades at different prices, even if the time is recorded independently, the floor participant has an opportunity to use information that may be only seconds old to cheat customers without detection. As a result, even independent timing to the nearest minute will not always allow for accurate sequencing of each floor participant's trades.

Finally, none of the exchanges time when floor participants receive customer orders. This time is crucial because it establishes when the participant assumes responsibility for promptly and competitively executing the orders. Without timing information on the complete history of each order, floor trade practice abuses could occur without detection and customers could be defrauded. Also, this information may provide the evidence needed to prove that certain abuses actually occurred.

CFTC proposed rule amendments in August 1989, tightening controls over the preparation and submission of trading cards and the submission of customer order tickets, that will improve timing information and trade sequencing. The rules could go into effect in early 1990, if approved. The exchanges have already begun implementing some of these changes as well as others. However, even if these rules are implemented, floor participants will still be relied on to provide accurate trading records, trade times will not be exact, and complete information on trades will not be available.

All four exchanges are exploring applications of new technology and automated systems that could provide more independent, precise, and complete trade timing. CBT and CME are studying and developing automated order routing systems to increase the efficiency of the futures trading process. All four exchanges are planning to develop electronic audit trail systems to record transactions using hand-held terminals. CME and CBT are also developing trading systems that will replace the current trading process and expand operations outside normal trading hours. NYMEX officials told us that they are planning a similar system. Under current plans, all these systems will not be fully implemented for more than 1 year, and the extent to which the exchanges will use these systems to control trading abuses is uncertain.

A lot of attention has been directed to the effect of dual trading on market integrity. Dual trading allows floor participants to trade for their personal accounts and those of customers on the same day. Market professionals generally agree that dual trading has several benefits, including increasing market liquidity. However, dual traders have the opportunity to trade ahead of customer orders and profit by making more trades than needed to fill their customer orders and then allocating the most favorable trades to their personal accounts and the least favorable trades to customers' accounts. This opportunity raises concerns about the extent to which dual traders are cheating customers and has led to proposals to restrict dual trading.

Restricting dual trading would not prevent floor brokers from using a third party to indirectly trade ahead of customers. In fact, the Justice Department indictments allege that some brokers were using third parties in an attempt to mask illegal trades. Trading ahead abuses could more easily be detected if trade times were independent, precise, and complete because the exact sequence and price of each floor participant's trades could be readily determined, as could the time when the floor broker received the order. Therefore, restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations. (See app. VII.)

Independent, precise, and complete trade timing, however achieved, should reduce the opportunity for certain trading abuses and should increase the probability that those committing certain trade practice abuses will be apprehended. (See app. I.) The time frame for achieving independent, precise, and complete timing is likely to be more than a year. Thus, CFTC's proposals should be implemented quickly to provide needed interim improvements in controls over trade practice abuses.

Recommendation

We recommend that CFTC direct the exchanges to independently, precisely, and completely time each trade and specify a time frame for meeting this requirement. Timing should be independent of the other trading data supplied by floor participants. Time recording should include the precise time the broker receives and records as executed each order as well as the precise execution times of noncustomer trades. CFTC should give the exchanges flexibility in deciding how to meet the requirement but should also establish firm implementation dates.

IMPROVING AUTOMATED SURVEILLANCE

Trade practice abuses can be detected by various means, such as manual review of the trade register, surveillance of the trading floor, and complaints from members. In addition, at different times between 1986 and 1989, the exchanges began using automated trade surveillance systems to more efficiently review all trading activity and to provide investigators with exception reports that highlight suspicious trading activity.

These systems can screen large volumes of trading data for potential abuses more efficiently than can manual methods.

However, as we have discussed, the audit trail data upon which these systems rely are too imprecise for screening programs to accurately identify all potential abuses, and some of the systems are still in the early stages of development.

CFTC reviews the parameters and output of screening programs to determine the appropriateness of the exception reports the programs generate. However, CFTC does not review system documentation or test screening programs to determine whether the surveillance systems are operating as intended. In addition, CFTC does not require that program documentation be independently assessed. Exchange officials told us that complete documentation is not always available that describes surveillance systems' initial design, any subsequent modifications, and test results of those modifications. Such documentation is needed to determine whether the systems are operating as intended. A CFTC or other independent test of screening programs could include running data containing known violations through the exchanges' systems. (See app. I.)

Recommendations

We recommend that CFTC

- -- require exchanges to maintain complete documentation of automated surveillance systems and
- -- expand its reviewing and testing of exchange automated surveillance systems, or require that they be independently reviewed and tested, to determine whether they are operating as intended.

ASSESSING DISCIPLINARY ACTION PROGRAMS

The number and severity of disciplinary actions that the exchanges have taken varies by exchange but has generally increased. From January 1, 1984, through June 30, 1989, the total number of floor participants penalized at each exchange ranged from a low of 17 at NYMEX to a high of 177 at CME; total fines ranged from $323,000 at NYMEX to $4,472,000 at CME; and total suspensions ranged from 304 business days at NYMEX to 13,562 business days at CME.

We were unable to evaluate the significance of these differences in exchange disciplinary actions because the universe of abuses is unknown, and the uniqueness and complexity of each case preclude any generalizations about the adequacy and consistency of penalties. Moreover, the results of comparisons of futures to securities market disciplinary actions are not useful in judging the futures market disciplinary actions because of differences in the types of abuses that occur in the two markets.

CFTC and exchange officials said that they are concerned about perceptions of potential conflicts of interest and about the fairness and consistency of the disciplinary action process. As a result, CFTC has issued proposed rules governing the eligibility of members with prior disciplinary histories to serve on disciplinary action committees. Also, the exchanges are considering actions, and in some cases have taken actions, that they believe will improve perceptions about the fairness and consistency of disciplinary action programs, including changing the composition of disciplinary committees and establishing minimum penalty guidelines. (See app. II.)

USING MANAGEMENT INFORMATION

CFTC uses investigatory and disciplinary action information to judge specific exchange decisions and to monitor exchange progress from one rule enforcement review to another. However, it does not formally analyze trends or compare results across exchanges.

Currently, CFTC uses exchange investigative logs to target problems and to gauge investigatory activity during a specific time period at a particular exchange. It uses disciplinary action notices, maintained in an automated database, to target particular disciplinary actions for further review and to measure disciplinary activity at a particular exchange.

CFTC cannot use this information to analyze trends and compare results among exchanges because no uniform definitions exist that would enable exchange officials and CFTC to classify investigations and disciplinary actions involving floor trade practice abuses. Such analyses and comparisons could help CFTC identify patterns in exchange oversight results that might highlight issues for review; show the relative effectiveness of different exchange approaches to detecting, investigating, and punishing abusers; and identify aspects of successful programs that all exchanges could adopt. For example, by tracking and comparing the exchanges' performance, CFTC could determine those detection methods that generate the most leads and could direct other exchanges to incorporate those methods, as appropriate. CFTC and the exchanges are beginning to develop uniform definitions. (See app. VIII.)

Recommendations

We recommend that CFTC

-- establish milestones for completing definitions of trade practice violations and trade practice investigations so that they can be consistently differentiated from other types of rule violations and so that the definitions are uniform across exchanges and

-- begin making formal trend and comparative analyses of exchange investigations and disciplinary actions.

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We discussed this report with CFTC, SEC, and exchange officials and have incorporated their comments where appropriate. Most of the officials agreed that implementing our recommendations would improve trade timing and therefore enhance the ability of CFTC and the exchanges to deter, detect, and punish trade practice abusers. COMEX officials were concerned that our recommendation for improved timing of trades is not technologically feasible in the near term. We believe that the technology the exchanges are researching and testing has the potential to provide cost-effective means of implementing our recommendations.

As arranged with the Committee, we are sending copies of this report to CFTC and to other interested parties. This report was prepared under the direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues. Major contributors are listed in appendix XIII.

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ABBREVIATIONS

Amex	American Stock Exchange
CBT	Chicago Board of Trade
CBOE	Chicago Board Options Exchange
CME	Chicago Mercantile Exchange
COMEX	Commodity Exchange, Inc.
CFTC	Commodity Futures Trading Commission
CTR	Computerized Trade Reconstruction
FBI	Federal Bureau of Investigation
ITS	Intermarket Trading System
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation
NYMEX	New York Mercantile Exchange
NYSE	New York Stock Exchange
OMB	Office of Management and Budget
OTC	Over-the-Counter
SEC	Securities and Exchange Commission

EFFECTIVENESS OF FUTURES EXCHANGE TRADE PRACTICE OVERSIGHT

How effective are the trade practice oversight systems, including computerized audit trail systems, at futures exchanges and, for comparison, in securities markets?

We could not directly determine the effectiveness of trade practice oversight programs because we do not know the relationship between the number of abuses that CFTC and the exchanges find and punish to the total number of abuses that occur. The full extent of abuses that occur is unknown, although the FBI investigations may provide more insight than has been available. The Department of Justice indictments indicate that the FBI found the same types of alleged abuses occurring in the CBT soybean and U.S. Treasury bond trading pits as in the CME Japanese yen and Swiss franc trading pits. The alleged abuses involved schemes to enrich floor participants in violation of the Commodity Exchange Act, CFTC regulations, and exchange rules. The glossary describes various abuses that can occur in the futures market and that the Justice Department indictments allege occurred at CBT and CME.

We focused on three indicators of the intensity or quality of efforts to deter, detect, and punish trade practice abusers--the adequacy of oversight controls, the number and nature of disciplinary actions taken, and the use of management information. In the following sections, we discuss opportunities for CFTC and the exchanges to improve their framework of controls by making audit trail data more reliable through independent, precise, and complete timing of trades and testing of automated surveillance systems. We also compared futures and securities audit trail and oversight systems but reached no conclusions. The number and nature of disciplinary actions and the use of management information are discussed in appendixes II and VIII, respectively.

Independently, Precisely, and Completely Timing Trades

Futures exchanges generally do not independently, precisely, and completely time all trades. Most of the types of abuses alleged in the Justice Department indictments could have been detected and documented with independent, precise, and complete timing of trades. CFTC and the exchanges have proposed, and in some cases have taken, actions that will improve timing information and the sequencing of trades. However, even if implemented, these actions will not result in independent, precise, or complete timing of trades. The exchanges are also exploring the potential of new technology and automated systems to provide more accurate timing data.

Independent timing of trades could prevent floor participants from using their knowledge of the market price in the immediate past to alter trading records and to conceal execution of trades at noncompetitive prices. Precise timing could be used to determine the exact sequencing of each floor participant's trades, thereby making it easier to detect abusers, particularly under active market conditions. Complete timing of trades, including the time the floor participant receives and executes trades, could help reconstruct the history of each trade, not only to detect potential abuses, but also to prove that they occurred.

Currently, dishonest floor participants, working alone or with a third party, can eliminate the risk of unfavorable market movements. They can manipulate the information on the trading records to give noncompetitive trades the false appearance of having been competitively executed at an earlier time when prices were more favorable to them. These practices could be deterred or more easily detected through improved timing of trades.

Exchanges attempt to reconstruct the sequence of trades using times that may be based on inaccurate or incomplete information. The reconstructed sequence of trades and the timing information used to determine the sequence are then used along with an exchange record of the times of price changes[1] to detect and investigate floor trade practice abuses.

The timing information used to reconstruct the sequence of trades is part of the "audit trail," which is the documentation for all trades. The on-floor audit trail for a customer order begins when an order ticket is prepared and time-stamped at a trading booth on the exchange floor. Except at NYMEX, the audit trail for trades not involving customers begins when the floor participant[2] completes an entry on a trading card. At NYMEX, it begins when the seller completes a special card, called a pit card.

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[1] CFTC requires exchange employees to record all changes in prices to at least the nearest 10 seconds as trades are executed.

[2] Two basic types of floor participants are found in the futures pits--floor traders and floor brokers. Floor traders deal exclusively for their personal accounts and do not handle customer orders. In contrast, floor brokers may trade for themselves and others.

When any trade is executed, floor participants are required to record trading information on a trading card or customer order ticket. The information may include quantity, price, opposite broker, transaction date, and timing information. The trading card may also include trade sequence. After a customer order is executed, the corresponding order ticket is returned to the floor trading booth, where it is again time-stamped. At NYMEX, the selling floor participant is required to complete a pit card that includes some of the same information that is on the trading card; however, the exchange provides the transaction date and time.

CFTC requires each exchange to prepare a trade register that shows, for each cleared or matched trade, the execution time to the nearest minute. CFTC allowed the exchanges to develop individual audit trail systems to meet this 1-minute timing standard and required that the exchanges be able to report on the accuracy of the information. Each exchange has its own requirements for reporting timing information in audit trail source records and procedures for incorporating data from these records into its audit trail database. Although all audit trail data are available to prove a case once a potential abuse is identified, only the data entered into the audit trail system are used for routine surveillance.

To the extent that the audit trail is dependent on floor participants to accurately record trade time and sequence information at CBT, CME, and COMEX, opportunities exist to manipulate reported trade times and, therefore, the subsequent sequencing of trades. Because trading cards are currently required to be collected every 30 minutes or even less often, sufficient time exists for floor participants to alter trading records. Also, because many price changes may occur within this time, the floor participant has the opportunity to use historical prices in an attempt to conceal abuses. At NYMEX, sellers cannot manipulate reported trade times because the exchange assigns the time upon receipt of the pit cards sellers submit--sellers are required to submit these cards within a minute of execution.

For surveillance systems to be effectively used in detecting abuses, trade timing must not only be free from participant manipulation, but it also must be precise enough to allow complete and accurate trade sequencing. While CFTC requires exchanges to report trading times to the nearest minute, a single minute during certain trading periods in an active market may include hundreds of trades. Because a single floor participant could have executed a number of these trades at different prices, even if the time is recorded independently, as at NYMEX, the floor participant has an opportunity, even within a 1-minute period, to use information that is only seconds old to cheat customers without detection. As a result, even independent timing to the nearest minute will not always allow for accurate sequencing of each floor participant's trades. COMEX does not sequence trades within a single minute because, in its case, floor participants are only required to report trades to the nearest minute. CBT and CME attempt more precise trade sequencing, but this sequencing may not always be reliable.

Finally, the audit trail system must incorporate complete timing information on key events in the handling of each customer order for the entire period it is on the exchange floor. To the extent that the audit trail does not independently or precisely identify when orders are received, executed, and moved off the floor, an opportunity exists for dishonest floor participants to violate trading rules without detection by manipulating trade records. Although order ticket entry and exit times must be stamped on each order, only CBT and CME enter entry time stamps into their audit trail databases and none of the exchanges enter the exit time stamps for use in routine surveillance.

Additionally, none of the exchanges time when floor participants receive customer orders. This time is crucial because it establishes when the floor broker assumes responsibility for promptly and competitively executing the orders. By knowing when the floor broker received an order and the type of order, such as market[3] or limit[4] order, the quality of the order fill can be assessed in relationship to prices prevailing when the order should have been filled. Without timing information on the complete history of each order, floor trade practice abuses could occur without detection and customers could be defrauded. Also, this information may provide the evidence needed to prove that certain abuses actually occurred.

COMEX floor participants on both sides of the trade manually record the trade time to the nearest minute. Therefore, the accuracy of these times in the COMEX system is dependent on floor participants correctly recording trade execution times. To verify the participant-reported times, COMEX compares the times reported by each side of the trade and matches each of these times against its price change report. It may impose fines on members submitting times inconsistent with the other side of the trade or with the price change report. However, participants deliberately manipulating trade times may be able to make their times consistent to avoid detection.

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[3] A market order is one to buy or sell a futures contract at whatever price is attainable at the time it enters the pit.

[4] A limit order is one in which the customer specifies a price limit or other conditions for order execution.

At NYMEX, sellers are required to submit the pit card to a NYMEX official within a minute of trade execution. Sellers submit the card by throwing it into a net in the middle of the exchange pit from which the exchange official then retrieves and time stamps it. Although NYMEX times are independent of floor participants, this system has some limitations in achieving precise 1-minute timing and sequencing of all trades. First, sellers may not always complete and submit their pit cards to the exchange officials fast enough to have them time-stamped in the same minute in which the trade was executed. Second, even if sellers promptly complete and submit pit cards, the NYMEX official timing them may not time-stamp them in the exact order in which they were received or in the same minute during which the trade was executed.

The mechanical timing process NYMEX uses makes any further increases in timing precision difficult. In addition, sellers may fail to promptly submit a pit card, or may not submit a card at all, as part of a scheme to conceal a trade practice abuse. Because buyers do not record or submit trade timing data, sellers can delay the reported time of trade execution without collusion from the buyer.

Like COMEX, NYMEX uses its time and sales record as a means of verifying 1-minute execution times. If the time-stamp is inconsistent with its price change reports, indicating late submission of pit cards, the seller may be subject to a fine.

CME and CBT have computerized trade reconstruction (CTR) systems that use a series of logical steps to impute 1-minute trade times from audit trail data. The accuracy of the trade times that these systems generate partially depends on audit trail timing data that floor participants submit. For example, when a trade is executed, CME and CBT require floor participants to record a letter that corresponds to an exchange-designated, half-hour trading period, which the CTR system uses with other information to impute 1-minute trade times.[5]

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[5] The CTR system will sometimes ignore participant-provided timing information that is inconsistent with other audit trail records.

CFTC identified some problems in the logic CTR systems use that were leading to incorrect trade times. For example, at both CBT and CME, CFTC found that CTR imputed times for some trades before the trade reached the floor order booth or after it was reported to the floor order booth as executed. CFTC also found that the CBT CTR system may also impute incorrect times because it does not use all key timing data.

CME, NYMEX, and COMEX report that 84, 85, and 87 percent of trade times, respectively, can be verified as meeting the 1-minute timing standard. CFTC officials told us that CBT does not have a method for reporting on the accuracy of its trade times. The other three exchanges use methods that rely heavily on the record of price changes to either derive or test the accuracy of reported execution times. To the extent that floor participants can manipulate timing information to make illegal trades appear to have been executed in conformity with the record of price changes, either by recording incorrect information on trading cards and order tickets or by withholding the submission of pit cards, these reported verification rates may not be reliable.

CFTC and Exchange Initiatives

CFTC proposed rule amendments in August 1989, tightening controls over the preparation and submission of trading cards and the submission of order tickets that will improve timing information and trade sequencing. Some of these rules are already in effect at one or more of the exchanges. The rules include a variety of requirements designed to make it more difficult to manipulate audit trail records.

The proposed rules include requiring that trading cards (1) contain preprinted identifying information that would permit sequencing, distinguish each member's records from those of other members, and distinguish each such record from others prepared by a member over a 1-week period; (2) be time-stamped promptly upon completion; (3) be accounted for in exact numerical sequence, regardless of whether the card was voided or unused; and (4) be submitted to the exchange or clearing member at intervals, initially not to exceed 30 minutes, subsequently to be reduced to 15 minutes. The latter would also apply to order tickets.

The rules would also require that floor participants submit trading cards within 5 minutes or less of the market close and identify trades made at the opening and closing of trading--periods ranging from 30 seconds to several minutes in length. According to a CFTC official, these are the most active and volatile trading times, and the additional information required by the proposal is needed to help CFTC and the exchanges to better sequence trades during these periods.

If approved, the rules could go into effect in early 1990. The exchanges have already begun implementing some of these changes, as well as others. However, even if these rules are implemented, floor participants will still be relied on to provide accurate trading records, trade times will not be exact, and complete information on trades will not be available. Additionally, CFTC has issued an interpretation, effective immediately, which reaffirms the need for exchanges to maintain complete records for several kinds of trading errors.

The President of the Futures Industry Association, a national trade association composed of more than 100 of the largest futures brokerage firms, said that more precise timing than the current 1-minute standard will probably not be feasible for systems that manually record trade times and will likely require increased automation. In fact, the exchanges are exploring applications of new technology and automated systems that could provide more independent, precise, and complete timing during normal hours under open-outcry trading. CBT, CME, and NYMEX are also exploring after-hours electronic trading systems. Although some of these systems are not being designed primarily to perfect timing information, this may be one result of their implementation. These systems will also facilitate the detection of abuses if the information is incorporated into the audit trail.

CBT and CME are pilot testing automated order-routing systems that will independently record order-entry times to the nearest one-hundredth of a second and report them to the nearest second. The systems will also record the time orders are entered into the systems after they are executed. If integrated into the audit trail, these data will better define the period within which the order must have been executed, thereby improving trade timing capabilities. The systems will not, by themselves, provide the times that brokers receive or execute customer orders.

All four exchanges are investigating hand-held trading terminals for use under open-outcry trading. COMEX and NYMEX officials told us that their exchanges are jointly developing a hand-held trading terminal. In August 1989, CME and CBT announced that they had committed a total of $5,000,000 to developing an automated data input terminal system. The terminals are expected to have controls that will provide independent times for order receipt and execution and that will prevent brokers from changing entered execution times. Adding this system to automated order-routing systems would allow exchanges to determine exactly when brokers received and executed customer orders. If configured as planned, this technology would make it more difficult for brokers to manipulate audit trail records and avoid detection.

The proposed system will use hand-held electronic trading terminals in place of trading cards and order tickets. The terminals will record the times that trades enter and are executed in each trading pit. The system is also intended to include stationary broker work stations that can be used to receive incoming orders from exchanges' planned order routing systems. CME and CBT officials are optimistic that a workable hand-held terminal can be deployed within 1 year for floor traders. Integration of the floor trader terminals with proposed order entry systems is expected to take longer than a year.

CBT, and CME, are currently developing automated trading systems for after-hours trading. NYMEX officials told us that they are planning a similar system. Our review was limited to the CBT and CME systems. Both systems include controls that would make certain types of trade practice abuses more difficult. For example, prearranging trades to execute customer orders outside of the current market prices would be very difficult. These trading systems would also generate an audit trail that includes precise timing of all trading activity to the nearest one-hundredth of a second. Exchange officials expect some type of automated after-hours trading system to be in place in less than 1 year. To reduce costs to exchange members, CBT and CME are discussing working together on a joint after-hours trading system.

While these automated improvements to open-outcry trading and after-hours trading systems would provide more precise trade times, they are only now being tested and others are still under development. Under current plans, exchange officials expect enhancements to the open-outcry system to be phased in over the next several years, although parts of the system are expected to be in place before the end of 1990. After-hours automated trading systems may be operational somewhat sooner.

Conclusions

Independent, precise, and complete trade timing, however achieved, should reduce the opportunity for certain trading abuses and should increase the probability that those committing certain trade practice abuses will be apprehended. The time frame for achieving precise, independent, and complete timing is likely to be more than a year. Thus, CFTC's proposals should be implemented quickly to provide needed interim improvement in controls over trade practice abuses.

Recommendation

We recommend that CFTC direct the exchanges to independently, precisely, and completely time each trade and specify a time frame for meeting this requirement. Timing should be independent of the other trading data supplied by floor participants. Time recording should include the precise time the broker receives and records as executed each order, as well as the precise execution times of noncustomer trades. CFTC should give the exchanges flexibility in deciding how to meet the requirement but should also establish firm implementation dates.

Improving Automated Surveillance

CFTC regulations require that exchanges maintain a program for deterring, detecting, and punishing trade practice abusers. Originally, exchanges complied with this requirement, in part, by manually reviewing their trade registers. At different times between 1986 and 1989, the exchanges began using automated trade surveillance systems to more efficiently review all trading activity and to provide investigators with exception reports that highlight suspicious trading activity. CME and CBT implemented their systems in 1986. However, although CME immediately began 100-percent coverage of trading activity, until 1989, CBT used its system to review a sample of trades. NYMEX and COMEX started using their screening programs in 1988 and 1989, respectively.

Trade practice abuses can be detected by various means, such as manual review of the trade register, surveillance of the trading floor, and complaints from members. In addition, automated surveillance systems can screen large volumes of trading data for potential abuses more efficiently than can manual methods. We have already discussed how improved timing data would enhance the ability of these systems to detect abuses that involve floor participants taking advantage of past trading times and prices to cheat customers. Identifying abuses that do not involve floor participants taking advantage of knowledge of past information requires analysis of trading patterns that may not be facilitated by exact sequencing. Some of these involve floor participants trading at competitive market prices, such as with a favored colleague, but not by open-outcry. These abuses could be identified by reviewing the frequency with which a floor participant trades with the same person or by reviewing other trading patterns.

While the exchanges are continuing to upgrade their systems, CFTC officials said that the exchanges could make better use of existing systems in detecting trade practice abusers. CFTC officials also said that they have been concerned about the few disciplinary actions resulting from automated surveillance.

The exchanges are planning further enhancements to their present systems' capabilities that they expect to increase the number of productive leads. For example, CME, CBT, and NYMEX plan to incorporate trading profiles for exchange members in their programs that will highlight abnormal broker trading and/or profits. COMEX recently implemented an automated trading-ahead surveillance program that incorporates individual trading profiles, and CME and CBT are developing advanced data retrieval programs. In addition, CBT has announced that CME and CBT have agreed to unify their existing computerized surveillance programs. Timeframes for implementing these enhancements, however, are uncertain.

CFTC needs to upgrade its oversight of exchange automated surveillance systems. CFTC reviews the parameters and the output of the screening programs to determine the appropriateness of the exception reports the programs generate. In certain cases, CFTC has asked exchanges to modify their systems to better identify leads. However, CFTC does not review system documentation or test screening programs to determine whether the surveillance systems are operating as intended. In addition, CFTC does not require that program documentation be independently assessed.

Exchange officials said that complete documentation is not always available that describes surveillance system initial design, any subsequent modifications, and test results of those modifications. Such documentation is important in determining whether systems are operating as intended. While CME and CBT initially prepared system specifications and plans, the documentation has not been updated to reflect extensive system modifications. Exchange officials said that they tested both the initial system and all subsequent enhancements, but CFTC did not review these. Likewise, CFTC does not independently test the screening programs to determine whether surveillance systems are operating as the exchanges intend, or otherwise require that they be independently assessed. CFTC or other independent tests of screening programs could include running data containing known abuses, called a test deck, through the exchanges' systems.

Conclusions

Improved trading information should improve exchanges' ability to detect and document trade practice abuses. However, audit trail enhancements will have little impact unless the exchanges can effectively analyze the enhanced data. CFTC needs to upgrade its oversight of the exchanges' automated surveillance systems.

Two techniques can help CFTC strengthen its oversight. First, CFTC needs to require exchanges to prepare and maintain system documentation, including test results. By reviewing such documentation or requiring that it be independently reviewed, CFTC can be more confident of assessing the appropriateness of system design and changes to that design. Second, CFTC should test exchanges' automated surveillance systems, or require that an independent party do so, to judge the ability of these systems to detect abuses.

Recommendations

We recommend that CFTC

- require exchanges to maintain complete documentation of automated surveillance systems and
- expand its reviewing and testing of exchange automated surveillance systems, or require that they be independently reviewed and tested, to determine whether they are operating as intended.

Futures and Securities Trade Practice Oversight Programs

Comparisons between the oversight of the futures and securities markets for trade practice abuses are complicated because the trading systems in the two markets are different. These differences, as well as the differences in the instruments traded, result in different kinds of abuses occurring in each market. As a result, although the audit trail and surveillance systems used to detect and document floor trade practice abuses in securities markets use some of the same general approaches as used in the futures markets, the details of the systems are very different, making comparisons difficult. However, CFTC and SEC are organized similarly to oversee trade practice abuses, and they have similar surveillance activities.

Differences in trading systems

While futures are traded in an open-outcry system in which floor brokers and floor traders compete for bids and offers, NYSE and Amex use a specialist[6] system that provides for more structured markets. NASD and CBOE have a multiple market-maker[7] system with some similar features. Specialists have responsibility for buying and selling assigned stocks when a temporary disparity exists between the supply and demand for the stocks. According to NYSE and Amex officials, the structure of securities markets plays a role in the types of abuses that can occur on the exchange floor. As a result, more abuses are likely to occur off the exchange floor--among them insider trading.

Comparison of audit trail and oversight systems

Each of the securities exchanges has its own audit trail system that is used to record information on each transaction, including the time of execution. At NYSE and Amex, approximately 80 percent of all transactions are routed to specialists via automated order routing systems, and the time that specialists execute these trades is independently, precisely, and completely recorded. Trades involving brokers are recorded by exchange employees.

CBOE relies on floor participants to record the execution times of most trades. However, about 15 percent of all trades are executed automatically through a small order execution system that independently, precisely, and completely records trade times. Similarly, NASD relies on market makers to report most execution times, while about 7 percent of trades are independently, precisely, and completely timed by an automated small order execution system.[8] Like the futures exchanges, the securities exchanges are moving towards more precise and independent trade times and have implemented or are considering some of the same types of technology that are now being considered in the futures markets.

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[6] Specialists are exchange members who function as both brokers and dealers in fulfilling their primary obligation to maintain fair and orderly markets in the stocks the exchange assigns to them by buying or selling assigned stocks when a temporary disparity exists between the supply and demand for the stocks. As brokers, specialists act on behalf of others who entrust to them orders that cannot be executed until specified execution prices have been reached. As dealers, specialists facilitate orderly price movements by buying stock for their own accounts when sellers outnumber buyers and by selling stock from their accounts when buyers outnumber sellers.

[7] Market makers are options traders and exchange members who trade for their own accounts. Like specialists, they are responsible for maintaining fair and orderly markets. Over-the-counter market makers have few obligations. A primary obligation is to maintain a continuous two-sided price quote for their own accounts.

As in the futures markets, once trading data are entered into audit trail systems, the securities exchanges review these records with varying levels of computer assistance in an attempt to identify unusual price and volume movements, as well as specific instances of potential trading abuses. The major difference between the securities and futures market oversight programs appears to be securities markets' emphasis on monitoring for unusual price and volume movements. Because futures trade practice abuses are not necessarily related to such unusual movements, this kind of analysis might not be as productive for detecting floor trade practice abuses in the futures markets. Additionally, NYSE and Amex maintain a specific oversight program designed to monitor the performance of specialists in meeting their obligations. Because futures participants do not have comparable obligations, similar programs do not exist in the futures markets. Like the futures markets, the securities markets have ongoing programs to apply more advanced automation techniques to trade practice oversight.

Federal oversight activities

Both CFTC and SEC rely on the self-regulatory organizations, which include the exchanges and NASD, to provide the primary defense against trade practice abuses. The self-regulatory organizations meet their responsibilities by setting and enforcing rules. CFTC and SEC oversight programs have similar features for ensuring that the exchanges carry out their regulatory responsibilities. Both do oversight reviews and a variety of other monitoring activities, including reviews of exchange disciplinary actions and investigative logs. (See app. VIII.) Unlike SEC, CFTC makes its oversight reports public. Both agencies use computerized database systems to assist in fulfilling their oversight responsibilities. (See app. IV.)

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[8] At NASD, the small order execution system handles customer orders of 1,000 or less shares of stock. At CBOE the retail automated execution system can electronically execute customer orders of 10 contracts or less of designated equity options.

CFTC and SEC refer trade practice abuse cases identified by their direct oversight activities to the appropriate exchange or their own enforcement division for further investigation. However, SEC refers most of its very few floor trade practice abuse cases to the appropriate exchange because it does not typically take enforcement action against individual floor trade practice abusers. Although SEC has the authority to take such action, it relies primarily on the exchange to pursue these cases. SEC officials said that the agency uses its resources to pursue issues, such as insider trading, that generally fall outside of exchange jurisdiction.

CFTC and SEC have the authority not only to discipline individuals, but also to discipline exchanges that fail to meet their obligations to enforce federal regulations and their own rules. Both agencies have taken such actions; however, without knowing the universe of violations, we could not measure their effectiveness in doing so.

EFFECTIVENESS OF EXCHANGE DISCIPLINARY PROGRAMS

How effective are futures exchange disciplinary programs? Include the consistency and severity of penalties assessed and the roles of compliance staffs and member committees at the futures exchanges and, for comparison, in securities markets.

The number and the severity of disciplinary actions that the exchanges have taken varies considerably. We were unable to evaluate the significance of the differences in exchange disciplinary actions because the universe of abuses is unknown, and the uniqueness and complexity of each case preclude generalizations about the adequacy and consistency of penalties. Moreover, the results of comparisons of futures to securities market disciplinary actions are not useful in judging the futures market disciplinary actions because of differences in the types of abuses that occur in the two markets. However, the increased number and severity of penalties for floor trade practice abuses since the FBI investigation became public appears to indicate an increased commitment by the exchanges to deterring, detecting, and punishing trade practice abusers.

CFTC and exchange officials are concerned about perceptions of potential conflicts of interest and about the fairness and consistency of the disciplinary action process. As a result, CFTC has issued proposed rules governing the eligibility of members with prior disciplinary histories to serve on disciplinary action committees. Also, the exchanges are considering actions, and in some cases have taken actions, that they believe will improve perceptions about the fairness and consistency of disciplinary action programs, including changing the composition of disciplinary committees and establishing minimum penalty guidelines.

Number and Severity of Actions

Table II.1 shows that the number and the severity of disciplinary actions the futures exchanges have taken over the part 5 1/2 years varies by exchange, but have generally increased. From January 1, 1984, through June 30, 1989, the total number of floor participants penalized at each exchange ranged from a low of 17 at NYMEX to a high of 177 at CME; total fines ranged from $323,000 at NYMEX to $4,472,000 at CME; and total suspensions ranged from 304 business days at NYMEX to 13,562 business days at CME.

CME, CBT, and COMEX disciplinary activity during the period January 1, 1987, through June 30, 1989, was higher than their activity in the previous 3 years. At CME, this result applies to all of the disciplinary categories shown. At CBT and COMEX, the number of permanent bars were higher in the earlier period.

In contrast, NYMEX shows less disciplinary activity of all types in the 1987 through 1989 period compared to the 1984 through 1986 period. NYMEX officials said that the exchange's relatively small number of disciplinary actions and the apparent weakening of its program were caused by problems with staff turnover, particularly in key positions, and low staffing levels in the compliance department. From 1987 through early 1988, NYMEX had three different trade practice surveillance managers. In 1989, NYMEX had eight trade practice investigators, in contrast to the two it had during most of 1987. NYMEX officials said that the increase in disciplinary actions taken in the first half of 1989 reflects increased surveillance staffing.

The number of floor participants penalized does not correspond to exchange size, as measured by the volume of contracts traded. Table II.1 shows the volume of contracts that CFTC reported each exchange traded from fiscal years 1984 through 1988. The ranking of exchanges by volume for 1987 and 1988, from highest to lowest, was CBT, CME, NYMEX, and COMEX. As already noted, CME led in most disciplinary action areas despite lagging behind CBT in trading volume.

Also, in 1987 and 1988, the number of floor participants penalized per contract traded was higher at COMEX, which had the lowest trading volume, than at CBT, which had the highest trading volume. NYMEX volume has exceeded COMEX volume in recent years, but COMEX has consistently had more disciplinary actions.

Table II.1:

Futures Floor Trade Practice Disciplinary Actions and Exchange Volume
(January 1, 1984, through June 30, 1989)

	1984	1985	1986	1987	1988	1989	Total
CBT							
Floor participants penalized	2	7	14	16	13	12	64
Fines (thousands of dollars)	30	260	156	162	180	1,196	1,984
Suspensions (business days)	819	381	1,012	2,222	6,104	20	10,558
Permanent bar	0	4	2	0	0	2	8
Trading volume (millions of contracts)	74	78	103	116	140	a	511
CME							
Floor participants penalized	4	33	27	38	51	24	177
Fines (thousands of dollars)	10	291	190	1,684	558	1,739	4,472
Suspensions (business days)	132	160	58	8,553	3,797	862	13,562
Permanent bar	0	0	0	4	1	2	7
Trading volume (millions of contracts)	43	54	67	80	78	a	322
NYMEX							
Floor participants penalized	6	1	5	0	2	3	17
Fines (thousands of dollars)	134	0	128	0	13	48	323
Suspensions (business days)	0	0	199	0	0	105	304
Permanent bar	1	1	0	0	0	0	2
Trading volume (millions of contracts)	5	7	13	22	33	a	80
COMEX							
Floor participants penalized	5	9	22	27	27	13	103
Fines (thousands of dollars)	248	388	421	649	613	375	2,694
Suspensions (business days)	0	147	232	707	411	242	1,739
Permanent bar	0	1	0	0	0	0	1
Trading volume (millions of contracts)	20	18	16	20	20	a	94

[a] Not available.

Source: GAO prepared the table from exchange disciplinary action notices. Trading volume data are from CFTC's annual reports.

Universe of Abuses

Directly measuring the total numbers and types of floor trade practice abuses that occur in the futures markets is difficult, if not impossible, because rule violators need to keep abuses hidden to avoid detection and punishment. The cases that exchanges investigate and disciplinary actions that they take provide an indication of the potential for and types of abuses that can occur. Undercover operations, such as those of the FBI, may also provide a gauge of abusive activity because agents can observe a range of activity that may escape current conventional surveillance programs.

Adequacy and Consistency of Penalties

We reviewed trade practice abuse disciplinary case files that had penalties imposed in 1987 and 1988 and were unable to identify cases in which abusers were, in our opinion, treated with extreme severity or leniency. Because of the dissimilarity among cases, we could not determine if similar cases received consistent penalties within an exchange or among exchanges. CFTC may provide some consistency for disciplinary actions through its rule enforcement reviews and through its continuing review of exchange disciplinary action notices.

We could not determine whether disciplinary action cases were similar and the actions taken comparable because each case typically involved several different abuses, occurring over varying periods of time, with different amounts of customer funds involved. In addition, according to exchange officials, when deciding what disciplinary action to take, exchanges considered many factors, including the dollar amount of customer funds and the number of trades involved, the disciplinary record of the offender, and the extent of cooperation the offender provided. The disciplinary committees determined penalties through a deliberative process that frequently included settlement negotiations similar to plea bargaining. The details of the disciplinary committee proceedings were not fully documented in exchange records.

In reviewing exchange disciplinary action programs, CFTC evaluates the timeliness and documentation of the disciplinary process and the adequacy of sanctions imposed. While CFTC did not identify timeliness problems at either CME or CBT in its most recent reviews, it did cite delays in the disciplinary process at both COMEX and NYMEX and made recommendations for improvement. COMEX also received a recommendation to improve its recordkeeping.

CFTC concluded that the sanctions imposed at all four exchanges were adequate and reasonably calculated to deter future violations. However, CFTC identified areas for improvement at both CME and COMEX. CFTC cited one CME case in which the sanction did not appear to consider the violator's recidivism and also noted that CME had no procedures to monitor compliance with exchange suspensions. At COMEX, CFTC found one instance in which the exchange had not referred a nonmember's possible illegal trading activity to CFTC for further action. According to CFTC officials, the exchanges have corrected these deficiencies by improving their policies, procedures, and practices.

Securities and Futures Market Disciplinary Actions

Disciplinary procedures in the securities markets are generally similar to those followed in the futures markets. In both markets, once a potential abuse is detected, the exchanges open an investigation and, with the exception of CBT and NYSE, send cases appearing to merit further action through a screening committee that determines if the case should proceed. If it proceeds, another review committee decides what, if any, penalty to assess. CBT and NYSE do not have screening committees. Instead, cases move directly from the investigation to the committee with sanctioning authority.

As in the futures markets, most securities cases result in negotiated settlements. Direct comparisons between futures and securities markets' disciplinary actions on floor trade practice abuses are complicated by the differences in the types of abuses that can occur in the two markets.

Table II.2 provides statistics on the number of disciplinary actions taken at the securities exchanges we visited. It is limited to disciplinary actions taken against market participants for floor trade practice abuses. A list of the abuses covered and their definitions is found in the glossary.

In addition to their disciplinary action programs, NYSE and Amex have an action available to address poor market making performance by specialists that is not directly comparable to the futures markets or CBOE--reallocating their stocks to other specialists. According to exchange officials, the NYSE reallocated 11 stocks and AMEX reallocated 3 stocks during the period from January 1, 1984, through June 30, 1989. Like a suspension or an expulsion in the futures markets, this action deprives the specialist of income.

Table II.2:

Securities Floor Trade Practice Disciplinary Actions for Amex, NYSE, and CBOE (January 1, 1984, through June 30, 1989)

	1984	1985	1986	1987	1988	1989	Total
NYSE							
Floor participants penalized	4	10	9	12	6	6	47
Fines (thousands of dollars)	80	181.5	102.5	492.5	62	82.5	1,001
Permanent bar	0	0	0	1	0	0	1
Barred in supervisory specialist capacity	1	0	1	0	0	0	2
Suspensions (calendar days)	231	570	1150	2 ,007.5	0	540	4,498.5
Censures	4	7	9	4	4	5	33
Amex							
Floor participants penalized	7	9	4	6	5	1	32
Fines (thousands of dollars)	65.5	53.5	40	140	53	15	367
Permanent bar	0	0	2	0	0	0	2
Suspensions (calendar days)	0	0	0	1,980	554	10	2,544
Censures	3	2	3	5	5	1	19
CBOE							
Floor participants penalized	19	72	63	28	22	5	209
Fines (thousands of dollars)	38	107	71	78	71	8	373
Permanent bar	0	0	0	0	0	2	2
Suspensions (calendar days)	398	564	2,597	112	3,685	0	7,356
Censures	5	28	28	12	17	1	91

Note: According to exchange officials, these numbers do not include the reallocation of NYSE and Amex specialist stocks.

Source: GAO prepared the table from exchange disciplinary action data.

CFTC and Futures Exchange Actions

While the investigative staff who develop trade practice abuse cases are futures exchange employees, committees that screen the evidence and adjudicate the cases are composed of exchange members. CFTC, until recently, had no rules governing membership on exchange oversight committees. Instead, exchanges developed their own membership rules, which varied. However, all four exchanges have rules forbidding disciplinary committee members from hearing cases in which they have conflicts of interest.

In August 1989, CFTC issued a proposed rule prohibiting persons who have been sanctioned for major rule violations from serving on exchange governing boards, arbitration committees, and disciplinary committees for 3 years. This rule is likely to go into effect in early 1990.

The CME special review committee has proposed and NYMEX has adopted, subject to CFTC approval, a rule that includes voting nonmembers on all major disciplinary committees.

COMPLIANCE STAFF AND BUDGET SIZE

What are the relative budgets and sizes of compliance staffs at the futures exchanges and, for comparison, at securities markets?

We believe that differences in market structure make meaningful comparisons of the budgets and sizes of futures and securities exchange compliance departments virtually impossible. Even making these comparisons among futures exchanges is difficult because each exchange has a different organizational structure. We examined the relative size and experience of professional investigator staffs at futures exchanges. COMEX had the most investigators relative to contract volume[1] and CME and COMEX had the most experienced investigators as of June 30, 1989.

Futures and Securities Market Resources

The securities exchanges' budget data for floor trade practice abuse units are difficult to separate from the overall regulatory budgets, and consequently, cannot be compared to the data obtained from futures exchanges. Table III.1 shows budget and staffing data for the overall regulatory activities of both futures and securities exchanges. The differences among the exchanges budgets and staffing reflect differences in their size and regulatory responsibilities.

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[1] This assumes that the relationship between 1988 and 1989 contract volume remained constant over the first 6 months of 1989.

Table III.1:

Exchange Regulatory Budgets and Staff (1988)

Futures exchanges	Total budget (millions)	Number of staff
CBT	$ 4.0	85
CME	3.1	86
NYMEX	2.4	37
COMEX	1.2	35
Securities exchanges		
NYSE	68.6	544
Amex	16.1	121
CBOE	3.9	103
NASD	76.6	927

Source: The exchanges.

Futures Market Compliance Budgets

Table III.2 shows compliance department budgets at the four exchanges. Because of differences in organizational structure and how exchanges reported the information, the numbers are not directly comparable.

Table III.2:

Compliance Department Budgets (1988)

Exchange	Total budget
CBT	$1,464,000
CME	1,171,000
NYMEX	794,000
COMEX	587,000

Note: The CBT and NYMEX data are estimates of the trade practice program portion of budgets for organizational units with broader responsibilities. The CME data are for the entire compliance department. The COMEX data are for trade practice staff's salary only.

Source: The exchanges.

Sizes and Experience of Futures Investigative Staffs

The number of trade practice investigators each futures exchange employs is one measure by which to compare the relative size of its compliance department. The Chicago exchanges are generally larger and have more investigative staff than do the New York exchanges. As table III.3 illustrates, an analysis of staffing by contract volume shows some differences among exchanges. For example, COMEX had the most investigators relative to contract volume as of June 30, 1989. Also, a CBT investigator monitored almost 50 percent more contract volume than a CME investigator monitored at this date.

Table III.3:

Number of Professional Investigatory Staff

Exchange	Contract volume 1/01/89 through 6/30/89 (millions)	Number of investigators as of 6/30/89	Annualized contract volume per investigator[a] (millions)
CBT	73	22	6.6
CME	55	24	4.6
NYMEX	21	9[b]	4.7
COMEX	10	10	2.0

Note: Data do not include exchange compliance directors.

[a] Calculated by dividing the contract volume by the number of investigators and multiplying by two.

[b] One of these positions was vacant from April 1989 to July 1989.

Source: The exchanges and the Futures Industry Association.

The number of investigators at each exchange is not in itself indicative of program effectiveness. Exchange officials said that because of the complexity of many trade abuses and the circumstantial nature of much of the evidence, staff familiarity with trading techniques and experience in developing a case are important. Table III.4 lists the number of professional investigators by years of experience as exchange floor employees or investigators. The table shows that CME has the most experienced trade practice compliance staff of the four exchanges with 10 staff who have over 5 years of experience. COMEX and CBT rank second with four staff having over 5 years of experience, and NYMEX ranks third with two. Conversely, CBT has the most staff members, 10, with less than 1 year of experience; followed by NYMEX, with 4 staff; CME, with 2; and COMEX, with 1.

Table III.4:

Experience of Investigatory Staff
(As of June 30, 1989)

Exchange	5 years or more	Between 1 and 5 years	1 year or less
CBT	4	8	10
CME	10	12	2
NYMEX	2	3	4
COMEX	4	5	1

Source: The exchanges.

CFTC ENFORCEMENT PROGRAM AND RESOURCES

How effective are CFTC trade practice detection and enforcement programs? What is the potential impact of limited budget and staff resources on these programs?

We could not directly measure the effectiveness of CFTC's efforts to detect and discipline floor trade practice abuses because we do not know how many abuses are actually occurring in the market. This same lack of data prevents us from measuring the impact of any limitations that might exist in budget and staff resources on these programs. CFTC officials said, however, that their programs could be improved with additional resources.

CFTC Enforcement Program

CFTC's Division of Enforcement investigates potential trade practice abuses identified through various sources. The major source of CFTC trade practice enforcement actions is through trade practice investigations referred to the Division of Enforcement from the Division of Trading and Markets. According to CFTC officials, when Enforcement receives a referral, Trading and Markets has initially developed the case. Generally, however, additional proof is needed to establish whether a violation was actually committed. To complete an investigation, Enforcement investigators obtain evidence, including original audit trail source documents, and use it to reconstruct trading activity. They may also subpoena other evidence, such as bank records.

Once an investigation is completed, Enforcement determines if the evidence indicates a violation of the law or regulation. If so, Enforcement presents the case to the CFTC Commissioners. The Commissioners then determine whether a reason exists to issue a complaint. If CFTC issues a formal complaint, the case is filed with an administrative law judge or in federal court.

Table IV.1 shows that between January 1, 1984, and June 30, 1989, the trade practice disciplinary actions CFTC took at the four exchanges varied greatly. However, the data should not be used to draw any conclusions because some of the respondents include off-floor exchange members, and the universe of abuses at each exchange is unknown.

CFTC officials said that no actions were taken against NYMEX respondents during a period of minimal exchange disciplinary actions (see app. II) because, until mid-1987, the eastern region branch of the Division of Trading and Markets--the primary source of investigative leads for NYMEX and other New York exchanges--emphasized recordkeeping violations rather than trade practice abuses.

While CFTC took disciplinary actions against COMEX respondents between 1984 and 1986, CFTC Enforcement officials said that they could not readily determine the source of the leads used to generate the actions. However, Enforcement officials said that the eastern region made only one COMEX-related referral during this period. According to CFTC officials, the New York region's program emphasis has changed and currently includes surveillance for a wider range of trade practice abuses. As a result, since mid-1987, the number of referrals to Enforcement has increased for both NYMEX and the other New York exchanges.

Table IV.h

CFTC Trade Practice Disciplinary Actions (January 1, 1984, through June 30, 1989)

Exchange	Number of respondents penalized	Fines	Number of suspensions[a]	Number of revoked registrations[a]
CME	9	$170,000	0	5[b,c]
CBT	48	600,000	0	1[b]
COMEX	17	897,000	0	0
NYMEX	0	0	0	0
Other	36	945,000	3	1
Totals	110	$2,612,000	3	7

Note: The CFTC Division of Enforcement identified these cases as involving floor trade practice abuses. However, some cases involved both on-floor and off-floor activities and some of the respondents shown are not floor participants. For example, according to COMEX officials, more than half of the fines against COMEX respondents were against off-exchange respondents. This may also be true for the other exchanges.

[a] In fiscal year 1984, CFTC brought nine registration cases against floor brokers. We could not determine whether the registration action was based on trade practice violations.

[b] One individual's registration was revoked at both CME and CBT.

[c] One revocation is under appeal and another is pending.

Source: CFTC supplied the data; GAO categorized the data.

Additionally, CFTC has filed and simultaneously settled trade practice complaints against 8 of the 46 individuals indicted as a result of the FBI undercover investigation at CME and CBT. According to CFTC officials, settlement agreements provide that the individuals will never trade futures again either for their own or customer accounts.

CFTC Resources

We compared CFTC's budget request as submitted to the Office of Management and Budget (OMB), the OMB-approved request, and the funding Congress provided. This comparison shows that since 1984, OMB's approved request and CFTC's actual funding levels were typically less than CFTC had requested for both its overall operations and its trade practice programs. However, we could not determine the impact of the shortfall on CFTC trade practice programs. CFTC officials said that with more resources they would increase direct oversight of exchange programs and the frequency and the timeliness of some current activities. However, they would still rely primarily on the exchanges to oversee the markets and to discipline rule violators.

Table IV.2 shows that, except for fiscal year 1989, when OMB's approved request was greater than CFTC's request, and fiscal year 1984, when CFTC received greater funding than requested, CFTC has received less funding and staff than requested for its overall operations for every fiscal year from 1985 to 1989. In its fiscal year 1990 budget request, CFTC requested nearly a 10-percent increase in funding over its estimated fiscal year 1989 actual funding level, including almost a 13-percent increase for trade practice programs. It requested 10 additional staff-years over 1989 levels in its original fiscal year 1990 request and 10 more in an amendment, for a total increase of 20 staff-years.

CFTC submitted its original request for 10 additional staff-years to compensate for unfunded 1989 staffing. It submitted the budget amendment after the FBI and CFTC acknowledged the undercover investigation at the Chicago futures exchanges in hearings before the Committee. At the hearings, the Committee asked CFTC to evaluate its oversight procedures and consider a number of changes, many of which have resource implications. Of the 20 additional staff-years requested, CFTC said that it will devote 12 to trade practice programs and the remaining 8 to other programs.

Table IV.2:

OPIC Staffing and Budget
(Fiscal years 1984 through 1990)

	1984	1985	1986[a]	1987	1988	1989	1990
OPIC Request to OMB							
No. of staff	553	565	584	567	544	545	555[b]
Budget (thousands)	$26,156	$28,296	$31,943	$34,221	$34,012	$35,452	$37,984[b]
OMB-approved request							
No. of staff	523	533	533	508	518	545	c
Budget (thousands)	$24,691	$27,292	$27,222	$30,418	$32,813	$35,547	c
Actual funded levels							
No. of staff	492	512	480	491	510	535[d]	c
Budget (thousands)	$26,739	$27,564	$27,983	$29,761	$32,813	$34,723	c
Differences between OMB-approved and OPIC request							
No. of staff	-30	-32	-51	-59	-26	0	c
Budget (thousands)	-$1,465	-$1,004	-$4,721	-$3,803	-$1,199	+$95	c
Differences between funded levels and OPIC request							
No. of staff	-61	-53	-104	-76	-34	-10	c
Budget (thousands)	+$583	-$732	-$3,960	-$4,460	-$1,199	-$729	c

[a] Gramm-Rudman-Hollings budget limitations were implemented.

[b] OPIC's original fiscal year 1990 budget request was for 545 staff-years and $37,399,000. However, on March 29, 1989, OPIC sent a budget amendment to OMB that increased the staff-years by 10 and the budget by $585,000.

[c] Not available.

[d] Estimated.

Source: OPIC supplied the data; GAO calculated the differences.

Two CFTC divisions administer the agency's trade practice programs. The Division of Trading and Markets, Contract Markets Section, is responsible for trade practice surveillance, and the Division of Enforcement is responsible for investigating and prosecuting trade practice abusers.

Table IV.3 shows CFTC budget data for the Contract Markets Section. Since fiscal year 1985, the OMB-approved request and the funding Congress provided were the same as or lower than what CFTC requested for staff and funds. In fiscal years 1984 and 1985, the OMB-approved request and the actual funding levels were higher than that requested. Of the 12 additional staff CFTC recently requested for its trade practice programs in fiscal year 1990, CFTC officials said that 5 will be assigned to the Contract Markets Section for doing trade practice surveillance. The Director of Trading and Markets said that with additional resources the group could do more rule enforcement reviews, direct floor surveillance, and automation-related assessments.

Table IV.3:

CFTC Contract Markets Section Staffing and Budget (Fiscal years 1984 through 1990)

	1984	1985	1986[a]	1987	1988	1989	1990
CFTC request to OMB							
No. of staff	36.6	33	37	40	41	42	41[b]
Budget (thousands)	$1,515	$1,514	$1,947	$2,146	$2,457	$2,509	$2,617[b]
OMB-approved request							
No. of staff	36.6	33	31	35	37	42	c
Budget (Thousands)	$1,783	$1,550	$1,750	$1,896	$2,226	$2,507	c
Actual funded levels							
No. of staff	34	34	33	37	32	35[d]	c
Budget (thousands)	$1,640	$1,650	$1,734	$2,060	$1,878	$2,182[d]	c
Differences between OMB-approved and CFTC request							
No. of staff	0	0	-6	-5	-4	0	c
Budget (thousands)	$268	$36	-$197	-$250	-$231	-$2	c
Differences between funded levels and CFTC request							
Staff	-2.6	1	-4	-3	-9	-7	c
Budget (thousands)	$125	$136	-$213	-$86	-$579	-$327	c

[a] Gramm-Rudman-Hollings budget limitations were implemented.
[b] CFTC's original fiscal year 1990 budget request was for 36 staff-years and $2,324,000. However, on March 29, 1989, CFTC sent a budget amendment to OMB that increased the staff-years by 5 and the budget by $293,000.
[c] Not available.
[d] Estimated.

Source: CFTC supplied the data; GAO calculated the differences.

Table IV.4 shows CFTC budget data for Enforcement. The OMB-approved request and the actual funding levels for Enforcement were less than what CFTC requested in each fiscal year from 1984 to 1988. Additionally, in 1989, CFTC again received less actual funding than requested. Of the 12 additional staff that CFTC requested for its trade practice programs in fiscal year 1990, CFTC officials said that 7 will be assigned to Enforcement to investigate and prosecute trade practice abuses. CFTC officials said that they could speed case processing with an increase of approximately 10 staff. They said that processing time is not a problem, but greater speed is always desirable because swift justice is a good deterrent to abusive activity. With increases beyond this number and with better timing data, the division could increase the number of cases investigated and prosecuted.

Table IV.4

CFTC Division of Enforcement Staffing and Budget
(Fiscal years 1984 through 1990)

	1984	1985	1986[a]	1987	1988	1989	1990
CFTC request to OMB							
No. of staff	138	159	160	160	150	149	154[b]
Budget (thousands)	$6,821	$7,741	$8,318	$9,330	$9,018	$9,555	$10,118[b]
OMB-approved request							
No. of staff	131.2	139	111	131	139	149	c
Budget (thousands)	$6,566	$7,097	$6,379	$7,660	$8,574	$9,657	c
Actual funded levels							
No. of staff	109	125	118	125	136	144	c
Budget (thousands)	$5,545	$6,717	$6,621	$7,362	$8,203	$9,118	c
Differences between OMB-approved and CFTC request							
No. of staff	-6.8	-20	-49	-29	-11	0	c
Budget (thousands)	-$255	-$644	-$1,939	-$1,670	-$444	$102	c
Differences between funded levels and CFTC request							
No. of staff	-29	-34	-42	-35	-14	-5	c
Budget (thousands)	-$1,276	-$1,024	-$1,697	-$1,968	-$815	-$437	c

[a] Gramm-Rudman-Hollings budget limitations were implemented.

[b] CFTC's original fiscal year 1990 budget request was for 149 staff-years and $9,826,000. However, on March 29, 1989, CFTC sent a budget amendment to OMB that increased the staff-years by five and the budget by $292,000.

[c] Not available.

Source: CFTC supplied the data; GAO calculated the differences.

IMPACT OF HIGH TECHNOLOGY SYSTEMS

What impact will high technology systems have on efforts to detect and curb trading abuses, including the possible deployment of new electronic trading systems?

To provide independent, precise, and complete trade timing information, CBT and CME are jointly developing the Automated Data Input Terminal system that uses hand-held trading terminals[1] and electronic broker workstations in conjunction with an order routing system. This system is intended to meet the need for better audit trail data without eliminating the open-outcry trading process. The exchanges are also developing automated trading systems that will be used instead of the open-outcry trading process to allow for trading outside normal hours.

We found, as discussed in appendix I, that both of these initiatives could provide more accurate trade records to better detect certain abuses. Automated trading systems could also prevent some abuses. CFTC should oversee the design, development, and implementation of the exchanges' automation initiatives to ensure that the exchanges obtain the benefits these systems can provide in preventing and detecting trade practice abuses. More detailed information on our review of the automation initiatives of the Chicago futures exchanges can be found in our report entitled *Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks* (GAO/IMTEC-89-68, Sept. 7, 1989).

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[1] COMEX and NYMEX officials told us that their exchanges are also jointly developing a hand-held trading terminal.

GENERIC RISKS OF ELECTRONIC TRADING SYSTEMS

What are the potential benefits and problems associated with using electronic futures trading systems in place of, or in conjunction with, traditional oral outcry systems? Also, what are the unique vulnerabilities of these systems?

As the exchanges increase their use of and dependence on automation to do futures trading, they need to ensure that risks associated with automation use do not reduce the exchanges' ability to provide efficient, fair, and equitable treatment to all market participants. Automated systems, such as those planned to be used instead of the current open-outcry process during after hours, offer the potential for better prevention and detection of trade practice abuses. However, replacing manual processes with automation requires that controls exist to ensure that the systems correctly and fairly perform the operations assigned. Generic risks associated with automated systems need to be adequately controlled to ensure correct transaction processing, responsive operations, secure operations, and continuous service.

We believe that CFTC needs to provide resources to do technical assessments of the exchanges' automated system initiatives to ensure that the exchanges take adequate steps to control the risks associated with the use of automated systems. More detailed information on our review of the automation initiatives of the Chicago futures exchanges is provided in our report entitled Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

ROLES OF DUAL TRADING AND BROKER ASSOCIATIONS

What are the roles of dual trading and broker associations in the futures markets? Specifically, which exchanges permit these practices or groups? What rules or limits apply to them? How frequently are they involved in complaints or disciplinary actions? And, what type of complaints and disciplinary actions are associated with them?

A lot of attention has been directed to the effect of dual trading and broker associations on market integrity. Dual trading allows floor participants to trade for their personal accounts and those of customers on the same day. Market professionals generally agree that dual trading has several benefits, including increasing market liquidity. The primary abuse associated with dual trading--trading ahead of a customer order[1]--could more easily be detected if trade times were independent, precise, and complete because the exact sequence of each floor participant's trades could be readily determined, as could the time when the broker received the order. Restricting dual trading would not prevent floor brokers from using a third party to indirectly trade ahead of customers. In fact, the Justice Department indictments allege that some brokers were using third parties in an attempt to make illegal trades. Therefore, restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations.

Broker associations--groups of independent floor brokers that share customer orders, commissions, or expenses--may have negative effects on market competition because they provide incentives for association members to trade within the association rather than with other market participants. Some officials are also concerned that to the extent that associations use less-experienced, lower-paid brokers to fill customer orders, they can profitably charge low commissions, eventually driving nonaffiliated brokers out of business and reducing market liquidity. However, others defend broker associations on the grounds that associations are better capitalized than individual independent floor brokers. They also have a long-term commitment to their brokerage business that makes them willing to fill orders during chaotic periods, such as those occurring during the October market crash. Because association members trading in a particular pit in effect function as a single broker, intra-association trading can facilitate the same trade practice abuses as dual trading. However, these abuses can also be committed by collusion between two or more floor participants who are not members of an association. Regulators and market participants have become increasingly concerned over the role of broker associations. However, the regulation of broker associations is still in its early stages, except perhaps at CME, and the impact of broker associations on market competition and trade practice abuses is still unknown.

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[1] Trading ahead of a customer order is executing an order for one's personal account, or an account in which one has an interest, while having in hand any executable customer order in that contract.

Dual Trading

All futures exchanges currently allow dual trading. Although dual trading provides dishonest brokers the opportunity to cheat customers, exchanges have (1) rules that prohibit abusive practices by dual traders and (2) oversight programs that attempt to detect and punish rule violators. In addition, CME has unique rules that have discouraged dual trading in the Standard & Poor's 500 stock index contract.[2]

Disciplinary actions related to trading ahead of or trading against[3] customer orders are associated with the ability to dual trade. Exchange records did not contain enough information to allow us to readily determine the extent to which other disciplinary actions may be associated with the ability to dual trade. Table VIII.1 shows that dual trading abuses range from a low of 14 percent of the trade practice abusers penalized at CME to a high of 52 percent of those penalized at COMEX.

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[2] The Standard & Poor's 500 stock index futures contract is based on movement in the 500 stocks comprising the Standard & Poor's stock index.

[3] Trading against a customer order occurs when brokers noncompetitively take the other side of their own customers' orders, rather than competitively offering them to other floor participants, to the detriment of the customers or the other floor participants.

Table VII.1:

Floor Participants Penalized for Dual Trading-Related Abuses (January 1, 1984, through June 30, 1989)

Exchange	Total number of floor participants penalized	Number penalized for dual trading-related abuses	Percent penalized for dual trading-related abuses
CME	177	25	14
CBT	64	16	25
NYMEX	16	4	25
COMEX	103	54	52

Note: Dual trading-related abuses include trading ahead of or against customer orders.

Source: GAO prepared the table from exchange disciplinary action data.

Dual trading provides brokers an opportunity to trade ahead of, or against, customers. These opportunities have raised concerns about the extent to which dual traders are cheating customers and have led to proposals to restrict dual trading. Trading ahead can allow brokers to take advantage of their advance nonpublic knowledge of orders that have an effect on market prices. They can directly trade ahead of customer orders by making more trades than needed to fill their customer orders and by then allocating the most favorable trades to their personal accounts and the least favorable trades to customers' accounts. Or, they can indirectly trade ahead, as alleged in the Department of Justice indictments, by disclosing customer orders to other floor participants who then trade ahead of the orders. Brokers can then manipulate trading records and can report the trades in a different order or a different time than the trades actually occurred to make it appear that they traded for their own account before receiving the customer order.

Brokers profit from trading against customer orders by filling orders at worse prices than could be obtained competitively and by keeping the difference between the competitive price and the price given the customer. Exchange officials told us that directly trading against a customer is so easily detected that it is rarely attempted. However, as was alleged in the Department of Justice indictments, brokers can indirectly take the opposite side of customer orders by using other floor participants as intermediaries. The violators then use their knowledge of recent price changes to manipulate trading records to make it appear that they filled the customer orders at competitive prices.

Non-dual trading floor broker working together can trade ahead of and against customers. However, dual trading may facilitate these abuses by providing brokers with a personal account in which to capture their illegal profits. Without dual trading, colluding floor participants would have to find other means to transfer funds among themselves. CFTC officials said that dual trading makes abuses more likely to occur by giving brokers greater opportunity and capacity to commit abuses. Dual trading also adds to the public perception that futures markets are dishonest.

On the basis of membership concerns about abusive practices, in June 1987, CME implemented rule changes that substantially reduced dual trading in the Standard & Poor's 500 stock index futures contract. According to the CME special review committee report, the share of volume attributable to dual traders fell from over 50 percent to approximately 10 percent because of the rule changes.

The CME special committee to review exchange trading practices recommended that dual trading be prohibited, with several exceptions, in futures contracts that the exchange would determine have sufficient liquidity in the absence of dual trading. Instead of implementing this proposal, the CME Board of Governors adopted a rule change, subject to member referendum, under which dual trading would be allowed in any contract month[4] in which the verifiability of trade times exceeded a 90 percent accuracy standard.

CME set June 30, 1990, as the target date for implementing the proposed rule change. If a contract month failed to meet the 90 percent standard by that date, then dual trading would be prohibited with the same exceptions as proposed by the special review committee. That is, brokers could dual trade if they (1) had been given specific written authorization, to be renewed annually, from each and every public customer for whom they were filling orders; (2) were filling orders for other members; and

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[4] The contract month is the calendar month in which the futures contract matures and becomes deliverable.

(3) were predominantly conducting spread[5] transactions. Although CME has strongly defended dual trading in the past, the CME special committee reported that its proposals respond to the widely held belief that brokers use dual trading to cheat customers.

In House Agriculture Committee hearings, exchange officials testified that dual trading benefits market customers and is important for overall market liquidity and efficiency. Separately, CBT, COMEX, and NYMEX officials have defended dual trading. They said that dual traders provide better trade execution for customers and a flexible supply of brokerage services so that futures exchanges can quickly meet increases in customer order volume. These officials advocate deterring dual trading abuses through strong surveillance and disciplinary action programs.

While it is widely accepted that dual trading contributes to market liquidity, CME's experience with limiting dual trading in the Standard & Poor's 500 stock index futures contract appears to support the claim that limiting dual trading in mature liquid contracts may not necessarily harm market users. However, according to a CBT official, this lack of impact may be due to the particular characteristics of this contract, especially the low level of spread trading. Other commentators have also argued that the impact of restricting dual trading depends on many characteristics of the contract traded in addition to contract volume.

CFTC is assessing the role of dual trading in fostering trading abuses and the impact of dual trading restrictions on market liquidity. It plans to complete the study in October 1989.

While dual trading provides an opportunity for brokers to take advantage of customers, the Department of Justice indictments show that any abuse that a dual trading broker can commit alone can also be committed by non-dual trading brokers and traders working together. Therefore, it is unclear to what extent eliminating dual trading will reduce trade practice abuses. A better deterrent to trade practice abuses would be for the exchanges to precisely and independently time the progress of customer orders while they are on the exchange floor. If used properly, this timing data would better enable the exchanges to identify and document cases in which brokers provide their customers with prices inferior to those being competitively offered by other market participants.

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[5] A spread is the purchase of one futures delivery month against the sale of another futures delivery month of the same or related commodity.

Broker Associations

While all futures exchanges currently allow broker associations, no commonly agreed upon definition of these groups exists. CFTC expects to propose regulations establishing a uniform definition and uniform reporting requirements for such associations in the first quarter of fiscal year 1990. CME, NYMEX, and COMEX have restrictions on trading between affiliated members. Only CME calls these relationships broker associations. Data are unavailable on the number of complaints related to broker associations. Exchange officials said that with the exception of intra-association trading violations, no specific complaints are peculiar to broker associations and that data are not maintained on the number of actions against members of broker associations. Exchange officials also said that with the exception of intra-association trading violations, the disciplinary actions taken against broker association members are no different than those imposed for violations committed by other abusers.

Broker associations create a conflict of interest by providing incentives for association members to execute customer orders within the association rather than with other floor participants. They also provide an opportunity for abuse by providing incentives for association members to share information concerning customer orders and positions that may provide noncompetitive trading advantages to association members.

Critics are also concerned that nonassociation brokers may find it difficult to match the low commissions of association members and may eventually leave the markets. This could result in associations handling an increasingly large share of customer orders, thereby beginning to have some control over market pricing. Also, by reducing the number of floor participants, broker associations could potentially reduce market liquidity.

However, the CME special review committee noted that most experts it contacted stated that broker associations are beneficial because (1) capital is committed to covering all association members' trading errors; (2) well-organized associations can quickly respond to changing needs for brokers as demand for services shifts among trading pits; and (3) clearing members, in many cases, find it expedient to deal with one association in filling orders in more than one pit. The CME committee also noted that the combination of better capitalization and the long-term commitment of associations to their brokerage businesses appeared to have been a factor in the willingness of broker associations to fill orders in chaotic markets, such as those occurring in October 1987.

CME, NYMEX, and COMEX have rules restricting trading between members of the same broker association or affiliated members. CME rules restrict how often a broker association member can trade for customers and for their own accounts against members of the same association. CME limits intra-association personal account and customer order trading to 15 and 25 percent of a broker's monthly volume, respectively. However, its special review committee proposed banning broker association members from trading for their personal accounts with other members of the same association who are executing customer orders. According to a CME official, the exchange Board of Governors approved this proposal; however, it still must be reviewed by CFTC. NYMEX and COMEX officials told us they interpret their cross-trading[6] rules as prohibiting such trading. So that they can monitor compliance with their rules, CME and COMEX require broker association or affiliated members to register with the exchange, or to otherwise make their existence known.

The NYMEX regulatory review task force recommended that the exchange register members of informal broker affiliations. According to exchange officials, NYMEX currently records the names of those with formal broker affiliations. CBT is requiring members of broker associations to register so that their trading can be monitored. It has not limited intra-association trading because, according to a CBT official, no broker associations exist at CBT to the best of the exchanges' knowledge. The Futures Industry Association also supports registering broker group members so that they can be monitored, but believes that the decision on limiting their trading should be left to the exchanges. CFTC is studying issues related to the definition and regulation of broker associations.

Exchange disciplinary records do not typically identify whether rule violators are broker association members. The only disciplinary actions that we could associate with broker associations were those related to violations of CME's intra-association trading limits. Table VII.2 shows that CME has fined some floor participants for violating intra-association trading limits.

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[6] Cross-trading is the offsetting or noncompetitive match of the buy order of one customer against the sell order of another, a practice that is permissible only when executed as required by the Commodity Exchange Act, CFTC regulations, and exchange rules.

Table VII.2:

CME Intra-association Violations of Trading Limits

	1988	1989
Number penalized	14	20
Fines	$20,500	$37,500
Suspensions (business days)	5	10

Note: These figures are not included in GAO calculations of floor trade practice abuses because the violations are not necessarily serious trade practice abuses and because similar rules do not exist at other exchanges.

Source: GAO prepared the table from CME disciplinary action data.

USE OF MANAGEMENT INFORMATION

How do CFTC and the futures exchanges and, by comparison, the securities regulators, use the management information they collect on trade practice abuses to improve oversight systems, target patterns of abuse, or allocate scarce resources?

CFTC uses investigatory and disciplinary action information to judge specific exchange actions and to monitor exchange progress from one rule enforcement review to another. However, it does not formally analyze trends or compare results across exchanges. Currently, CFTC uses exchange investigative logs to target problems and gauge investigatory activity during a specific time period at a particular exchange. It uses disciplinary action notices, maintained in an automated database, to target particular disciplinary actions for further review and to measure disciplinary activity at a particular exchange. Finally, although CFTC and SEC collect and use floor trade practice abuse information to manage their programs in similar ways, unlike CFTC, SEC does some formal trend analyses.

CFTC cannot use its data to analyze trends and to compare results among exchanges because no uniform definitions exist that would enable exchange officials and CFTC to classify investigations and disciplinary actions involving floor trade practice abuses. Such analyses and comparisons could help CFTC identify patterns in exchange oversight results that might highlight issues for review; evaluate the relative effectiveness of different exchange approaches to detecting, investigating, and punishing abusers; and identify aspects of successful programs that all exchanges could adopt. For example, by tracking and comparing the exchanges' performance, CFTC could determine those detection methods that generate the most leads and could then direct other exchanges to incorporate these methods as appropriate.

CFTC and the exchanges are beginning to develop uniform definitions through the Joint Compliance Committee.[1] The differences in the number of disciplinary actions attributed to trade practice abuses that CFTC and the exchanges reported to this Committee illustrate this lack of uniformity in definitions. Furthermore, without consistent information from all the exchanges relating to trade practice investigations and disciplinary actions, CFTC cannot do formal trend analyses and exchange comparisons to accomplish the objectives we just described.

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[1] The Joint Compliance Committee first met in May 1989, under CFTC encouragement, to provide a forum for exchange officials to share information on exchange compliance procedures. The committee has no formal duties or authority, but represents a move toward more coordinated compliance efforts.

The exchanges define trade practice investigations differently. For example, CBT reports the results from computerized screening of trading data as trade practice investigations; COMEX, however, only reports instances in which it finds suggestions of suspicious activity after reviewing trading documents. A CFTC official said that although CFTC has not provided definitions of trade practice investigations, it evaluates exchange definitions during rule enforcement reviews to ensure that investigation logs accurately reflect investigative activity.

CFTC staff classify exchange-reported disciplinary actions in four general categories--"market surveillance," "financial," "trade practice," or "other." A CFTC official said that the classification is based on the staff's knowledge of the industry and familiarity with the information in the disciplinary action notices. While none of the categories have uniform definitions, he said that "trade practice" is the most ambiguous, thereby making accurate classification more difficult. For example, individual CFTC staff may decide differently on whether specific recordkeeping violations are trading abuses or other types of violations.

As a result of these classification problems, CFTC cannot analyze and compare specific kinds of abuses using its database. CFTC's computer is programmed to sort trading abuse information in only three ways--by the name of the exchange, by the name of the abuser, and by the general category of abuse. As a result, if CFTC needed information about a specific type of abuse, such as prearranged trading, staff would have to assemble and analyze the data manually.

A CFTC official said that the Joint Compliance Committee has reached a general consensus on definitions for trade practice investigations and violations but that no formal agreements have been made. Should the Joint Compliance Committee fail to reach a formal resolution at its upcoming October meeting, this official said that CFTC would issue a letter to the exchanges outlining its understanding of what the exchanges had agreed to and its expectation that the agreements would be implemented. Our recommendation to CFTC is designed to encourage this result.

Like CFTC, SEC collects information on exchange oversight efforts that staff use for several purposes, such as determining the scope of periodic oversight reviews. Unlike CFTC, SEC uses its database of exchange disciplinary actions to identify trends that suggest common problems across all exchanges. For example, from 1982 to 1984, SEC compared disciplinary action dismissals in the markets it regulates and found that except for one exchange, such dismissals rarely occurred. This trend indicated that most exchanges did not initiate disciplinary actions unless they had almost conclusive evidence to support a violation charge.

Conclusions

To better manage its oversight of exchange trade practice programs, CFTC needs to analyze information on investigations and disciplinary actions related to trade practice abuses to identify trends and to compare exchange results. To do this analysis, CFTC needs to ensure that information on trade practice abuse investigations and on disciplinary actions is consistent.

Recommendations

We recommend that CFTC

-- establish milestones for completing definitions of trade practice violations and trade practice investigations so that they can be consistently differentiated from other types of rule violations and so that the definitions are uniform across exchanges and

-- begin making formal trend and comparative analyses of exchange investigations and disciplinary actions.

FLOOR BROKER AND TRADER INCOME

How do exchange sanctions and fines against trade practice abusers compare with floor broker and trader income?

The exchanges could not provide us with any information on floor broker or trader income. Exchange officials said that they do not consider income when determining a sanction. Instead, they examine the severity of the abuse, especially the extent to which customers were harmed.

COMPARISON OF RULE ENFORCEMENT REVIEW RESULTS

How do rule enforcement review results for the New York futures exchanges compare with those for the Chicago exchanges?

CFTC found similar deficiencies during rule enforcement reviews at both the Chicago and New York exchanges. In its most recent reviews at the Chicago and New York exchanges, CFTC reported that each exchange needed to improve some aspect of its trade practice oversight or disciplinary action program, as well as its compliance department staffing and audit trail system.

OTHER FBI INVESTIGATIONS

Has the FBI conducted investigations at the New York futures exchanges or any other exchanges besides the Chicago exchanges? If so, would you provide a summary of the results of the investigations? If no FBI investigations have been conducted at the other exchanges, is there any reason for the lack of investigation at the other exchanges?

According to an FBI official, the agency has not done investigations similar to those at CME and CBT at any other exchange. These are the first such investigations the agency has done. They were undertaken through the initiative of the U.S. Attorney's Office for Northern Illinois, the jurisdiction of which includes the Chicago exchanges. The U.S. Department of Justice has announced that due to the apparent success of these investigations, similar operations may be undertaken elsewhere.

CFTC SANCTIONS

What sanctions can CFTC impose on individual brokers and traders and the futures exchanges? What additional sanctioning authority would GAO recommend that Congress provide to CFTC?

The Commodity Exchange Act authorizes CFTC to take injunctive and administrative actions against violators. Under injunctive actions, CFTC can obtain temporary restraining orders, preliminary and permanent injunctions, a freeze on violator assets, a receiver for the frozen assets, and other equitable relief that can be obtained from the federal courts. CFTC typically uses injunctive orders in "boiler room operation" cases so that CFTC can halt ongoing violations and freeze firm assets so as to compensate defrauded customers later. In these situations, CFTC can pursue further action against violators through the Department of Justice or a U.S. Attorney.

Administrative actions allow CFTC a wide range of penalties against exchanges and individuals. CFTC can penalize persons or firms by suspending or revoking trading privileges and registrations and by assessing a civil penalty of not more than $100,000 per violation. Similarly, CFTC can impose cease and desist orders and assess civil monetary penalties of up to $100,000 on contract markets, or on their officers or directors, for each violation. Finally, CFTC can either (1) suspend the exchange, for a maximum of 6 months, or (2) revoke the contract market designation of any exchange if it is not enforcing or has not enforced its rules or if the exchange, or any director, officer, agent, or employee of the exchange is violating or has violated any CME or CFTC rules, regulations, or orders.

CFTC officials, in their April 25, 1989, response to your request, reported that they believe that the penalties available to them against trade practice abusers are sufficient. We have no evidence to contradict their views. CFTC officials indicated, however, that they are concerned with two issues associated with sanctions and civil penalty collections. First, they recommended that the Commodity Exchange Act be amended to delete the requirement that CFTC consider net worth, size of business, or ability to continue in business in determining the amount of civil monetary penalties assessed. As a result of these considerations, CFTC officials said that in some cases they have not imposed the level of penalty that a particular violation may warrant. In other cases, CFTC's civil monetary penalties have been reduced or eliminated on appeal.

Second, CFTC recommended that the Commodity Exchange Act be amended to provide for an automatic trading prohibition and, if applicable, the automatic suspension of CFTC registration upon a failure to appeal or pay a civil monetary penalty order within 15 days from the due date. Typically, a person has 30 days to pay a monetary penalty imposed by an administrative law judge or CFTC as a result of a litigated decision. If the person fails to pay, CFTC can send a letter demanding payment and, if the fine is still unpaid, CFTC can refer the matter to a collection agency or ultimately to the Department of Justice. During this time, however, the person can continue trading on the exchanges.

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GLOSSARY[1]

FUTURES VIOLATIONS[2]

Accommodation Trading

Entering transactions to assist another floor participant in accomplishing improper trading objectives.

Bucketing

Failure to introduce an order to the marketplace, traditionally occurring when a floor broker noncompetitively takes the other side of a customer order to the detriment of the customer or other floor participants.

Cross-trading

Matching customer orders without offering them competitively.[3]

Cuffing

Delaying the filling of customer orders to benefit another member.

Curb Trading

Trading after the official close of trading.

Prearranged (Noncompetitive) Trading

Agreeing to some aspects of a transaction before it is openly executed on the exchange floor.

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[1] These are informational, not legal, definitions.

[2] Futures exchange rules also preclude disclosing customer orders except to the exchange or CFTC and allocating the best trades to one's own account or to that of preferred customers.

[3] Crossing the orders of two customers is generally permitted, provided the broker first offers the orders competitively and meets certain other regulatory requirements. CBT, with the exception of a stock index product, has chosen not to allow crossing orders because the exchange views it as incompatible with the open-outcry system. CME officials told us that the exchange allows this practice because under its rules the customer order is executed at a price better than it would otherwise have received.

Trading Against Customer Orders

Noncompetitively taking the other side of one's own customer's order, rather than competitively offering it to other floor participants, to the detriment of the customer or other floor participants.

Trading Ahead of Customer Orders

Trading for one's personal account, or an account in which one has an interest, while having in hand any executable customer order in that contract.

Wash Trading

Entering or purporting to enter into transactions to provide the appearance of trading activity without resulting in a change in market position.

SECURITIES VIOLATIONS

Excessive Mark Ups/Mark Downs

When an over-the-counter (OTC) securities dealer executes a trade for a customer from inventory and charges an undisclosed and excessive price for the trade. NASD rules define what is an excessive price.

Excessive Quote Spread

Failing to maintain appropriate differences, or spreads, between bid and offer prices. Market rules define excessive.

Failure to Honor a Market Quote

Failure of market makers to trade at their publicly disseminated price and size quotation.

Failure to Issue Intermarket Trading System (ITS) Preopening Notification

Preopening notification to other market makers is necessary whenever market makers, in arranging an opening transaction in their market in an ITS stock, anticipate that the opening transaction will be at a price that represents a certain level of change from the stock's previous day's consolidated closing price--the last price on the last day on which ITS transactions in the stock were reported--of more than an amount allowed by exchange rules. The violation is the failure to issue the preopening notification, preventing traders in other markets from participating in trading the orders.

Failure to Make a Market Quote

Failure of a market maker to stand ready both to buy and to sell at the market maker's quoted prices.

Fictitious Trades

Reports of transactions submitted to an exchange price reporting system that did not occur.

Frontrunning

Taking advantage of nonpublic information on an impending large transaction in one or more equities or derivatives of an equity when the markets adjust to the price at which the transaction occurs.

Illegal Short Sales

Selling listed securities the seller does not own, thereby causing a decline in market price (a minus tick), or at a price equal to that of the preceding transaction but lower than the last different price (a zero minus tick), in violation of SEC and self-regulatory organization rules.

Improper Cross Transactions

Pairing a purchase order with a sell order in the same security at the same time and price without following exchange rules and procedures.

Improper Stabilization Bid

Making a stabilizing bid, not in accordance with SEC rules, to facilitate a distribution of securities.

Market Making Violations--Excessive Destabilizing Trades by Floor Members

A pattern of excessive trading activity by floor members trading as principals in the same direction as the market is moving, rather than buying as market prices decline and selling as market prices rise, as exchange rules require. Exchange rules also determine what is excessive activity.

Market Making Violations--Failure to Properly Represent an Order in the Market

Failure by a specialist, market maker, or floor broker to ensure that an order receives proper execution pursuant to applicable terms of the order and in accordance with self-regulatory organization rules.

Market Making Violations--Specialist Investment Account Violation/NYSE

Limitation on the types of transactions a specialist can make while the specialist has an investment account position in a particular stock.

Market Making Violations--Unsatisfactory Performance by OTC Market Maker

A market maker's failure to perform according to market maker rules. It could refer to a number of violations, such as quoting an excessive difference between bid and ask prices.

Unsatisfactory performance also occurs when a market maker fails to accurately report volume, including failing to report that there was no volume.

Marking (Marking-the-close)

Making securities transactions or market quotations at or near the end of the trading session to increase or decrease the closing price.

Off-Board Trading

Transactions involving listed securities that were not executed on a national securities exchange in accordance with SEC and self-regulatory organization regulations.

Restriction on Acting as Market Maker and Floor Broker

Equities and options market makers are prohibited from acting as both a floor broker and a market maker for the same stock and for all options for the same underlying security on the same business day.

Stock Manipulation--Domination or Control

A pattern of trading or trade reporting designed to artificially influence the price or volume of a security. Such a pattern is established through controlling the supply or demand of a specific security.

Stock/Option Market Manipulation--Capping

Making stock transactions shortly prior to an option's expiration date to depress or prevent a rise in the stock price so that previously written call options--rights to buy a fixed amount of a given stock at a specified price within a limited period--will expire worthless and the premium received from them will be protected.

Stock/Option Market Manipulation--Pegging

Making stock transactions shortly before an option's expiration date to prevent a decline in the stock price so that previously written put options--rights to sell a fixed amount of a given stock at a specified price within a limited period--will expire worthless and the premiums received from them will be protected.

Stock/Option Market Manipulation--Mini-manipulation

An attempt to influence over a relatively small period of time, the price movement in a stock to benefit a previously established options position.

Stock/Option Market Manipulation--Trades Not Made in Open Outcry

Trades that are made without exposing the order to other floor participants and, therefore, without the opportunity for other traders to participate in the trade on the exchange floor.

Unauthorized Withdrawal/National Association of Securities Dealers Automated Quotation (NASDAQ) Market Maker

A NASDAQ market maker's failure to obtain permission from the National Association of Securities Dealers before withdrawing from the market. Unauthorized withdrawal may result in the market maker being unable to reenter quotes for 20 business days.

Unsatisfactory Market Maker/Specialist Performance

Conduct inconsistent with a specialist's obligation to maintain a fair and orderly market in accordance with the Securities Exchange Act and self-regulatory organization rules.

Unsatisfactory Performance by OTC Market Maker

A market maker's failure to perform according to market maker rules. It could refer to a number of violations, such as quoting an excessive difference between bid and ask prices.

Unsatisfactory performance also occurs when a market maker fails to accurately report volume, including failing to report that there was no volume.

Wash Trading

Entering into or purporting to enter into transactions to provide the appearance of trading activity without resulting in a change of position.

RELATED GAO PRODUCTS

Commodity Futures Trading Commission and the Chicago Futures Exchanges' Detection of Trade Practices Abuses (GAO/T-GGD-89-8, Feb. 23, 1989).

Chicago Futures Market: Initial Observations on Trade Practice Abuses (GAO/GGD-89-58, Mar. 13, 1989).

Futures Trading: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

(233236)

United States General Accounting Office

GAO

Report to the Chairman and Ranking Minority Member,
Committee on Agriculture, Nutrition, and Forestry,
United States Senate

September 1989

FUTURES MARKETS

Automation Can Enhance Detection of Trade Abuses But Introduces New Risks

Printed copies of this document will be available shortly.

GAO/IMTEC-89-68

GAO

United States
General Accounting Office
Washington, D.C. 20548

Information Management and
Technology Division

B-234478

September 7, 1989

The Honorable Patrick J. Leahy, Chairman
The Honorable Richard G. Lugar, Ranking
  Minority Member
Committee on Agriculture, Nutrition,
  and Forestry
United States Senate

A recent Federal Bureau of Investigation announcement on an undercover operation at the Chicago Board of Trade and the Chicago Mercantile Exchange alleged that a variety of illegal trading schemes were being used by floor brokers and traders to defraud customers. The investigation also raised questions about the effectiveness of the exchanges' controls on their open-outcry trading process to detect or prevent identified trade practice abuses.[1]

This report responds to your March 27, 1989, request and further discussions with your office in which you asked for information on the (1) potential benefits in using the Chicago futures exchanges' planned automated systems to detect or prevent trade practice abuses, (2) potential vulnerabilities associated with using automated systems in conjunction with or in place of the current open-outcry trading process, and (3) Commodity Futures Trading Commission's activities in assessing automated exchange systems. Responses to your remaining questions regarding the sufficiency and intensity of the Commission's efforts to identify and punish trading abusers are contained in another report.[2]

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[1] In the open-outcry trading process, traders verbally and through hand signals make bids and offers to each other at centralized trading floor locations, called trading pits. A description of the trading process and definitions of identified trade practice abuses are provided in appendix I.

[2] Futures Markets: Strengthening Trade Practice Oversight (GAO/GGD-89-120, Sept. 7, 1989).

In conducting our work, we reviewed documentation and interviewed officials at the Commission, the Chicago Board of Trade, and the Chicago Mercantile Exchange. Details of our objectives, scope, and methodology are included in appendix II.

PRINCIPAL FINDINGS

The Chicago Board of Trade and the Chicago Mercantile Exchange are studying and developing new automated systems. Automated order routing systems are being developed to increase the efficiency of the open-outcry trading process and better handle larger trading volumes. To better detect trade practice abuses in the open-outcry process, the exchanges recently announced a joint effort to develop an electronic audit trail system to record each trading transaction using hand-held terminals. In addition, the exchanges are developing after-hours trading systems, which will be used instead of the open-outcry process to expand operations outside normal trading hours.

If properly implemented, these planned automation initiatives can be used to more readily detect trading abuses because they can provide improved trade timing data. In addition, the exchanges plan to incorporate features in their after-hours trading systems that can prevent certain abuses. However, because these systems are still in the planning stage, the extent to which the exchanges will take advantage of technology to control trading abuses is uncertain.

Although the exchanges' planned systems have the potential to better control trading abuses, they introduce risks that must be addressed to ensure the correct processing of transactions, responsive operations, and secure and continuous service. The exchanges are aware of these risks and are taking steps to mitigate them.

The Commission's responsibility to safeguard market integrity and protect market participants against manipulation, abusive trade practices, and fraud in the marketplace require that it be involved in the technical assessments of exchanges' automated systems. However, the Commission has not been actively involved in conducting or setting guidelines for technical assessments of these systems' capabilities to control trading abuses and automation risks, and it does not have the necessary technical resources for such assessments. During our review, the Commission questioned the need to conduct technical assessments because it believed that the exchanges have a vested interest in developing sound systems. Commission officials later said that our review had increased their receptiveness to taking a more active role in reviewing the technical capabilities of exchanges' automated systems, and have, for example, contacted other government agencies to better understand the automation issues that should be included in technology assessments.

CONCLUSION AND RECOMMENDATION

As the futures exchanges become increasingly dependent upon automation, it is critical that the Commission take a greater leadership role to safeguard the integrity of the futures markets.

We recommend that the Chairman, Commodity Futures Trading Commission, acquire the necessary expertise to technically assess the systems planned by the futures exchanges. Such assessments should include analyses of proposed technical solutions and alternatives to ensure that the futures exchanges design, develop, and implement systems that maximize automation's potential to control trade practice abuses. The Commission should also assess the risks of using the exchanges' automated systems to ensure that they are adequately controlled.

To acquire the expertise needed for such assessments, the Commission needs to consider (1) obtaining its own technical resources, (2) requiring exchanges to have independent technical assessments performed on their systems under guidelines set by the Commission, and/or (3) creating a technical advisory committee consisting of government and private-sector representatives to advise the Commission on the relative merits and risks associated with using automated systems to better detect or prevent trade practice abuses.

The Chairman, Commodity Futures Trading Commission, agreed with our recommendation and said that she would acquire additional expertise and resources needed to ensure that adequate technical assessments of the exchanges' automated systems are performed.

BACKGROUND

In fiscal year 1988, the Chicago Board of Trade and the Chicago Mercantile Exchange traded 218.2 million futures contracts[3] and options on futures contracts. This represents 75 percent of the contract volume traded on the 14 domestic futures exchanges in 1988. Both exchanges trade these contracts through the open-outcry process. During active trading, this process can involve hundreds of floor participants simultaneously attempting to execute trades at highly volatile prices. In this process, floor participants can engage in several types of trade practice abuses to avoid competitive order executions. By avoiding competition, floor participants may secure a better transaction price at the expense of other market participants, including customers and other traders.

Identifying most trade practice abuses depends on accurate and complete documentation of the times and sequence of the trading activity. Currently, documentation is obtained from (1) manual records of timing and other information on trading cards and order tickets prepared by floor participants, (2) mechanical time-stamping of customer orders, and (3) exchange records on the timing of price changes. Exchanges use this information in audit trail and surveillance systems. Audit trail systems attempt to reconstruct to within 1 minute the most likely execution time of each trade. Surveillance systems analyze these audit trail data and generate reports on various trading patterns, which exchange surveillance staff use to help identify and investigate abuses.

In our March 1989 report,[4] we pointed out that because of trading record imprecision, the exchanges' audit trail systems may not precisely reconstruct the actual times and sequences for all trades. We noted that participants may intentionally or accidentally record erroneous trading data. We also reported that where exchange members trade with each other for their own accounts (instead of on behalf of customers), the trading data are not precise because traders are only required to report a 30-minute time bracket for such trades.[5] With such a large time bracket, it is difficult to use the automated audit trail systems to accurately determine times for these types of trades.

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[3] A futures contract is an agreement to purchase or sell a commodity for delivery in the future at a price that is determined at initiation of the contract.

[4] Chicago Futures Market: Initial Observations on Trade Practice Abuses (GAO/GGD-89-58, Mar. 13, 1989).

[5] For time recording purposes, the trading day is divided into 30-minute segments called brackets.

However, even if the manual records provided 1-minute accuracy for all trades, this information would not be sufficient to accurately identify all trade relationships for surveillance purposes. In this regard, exchange officials stated that during active trading periods it is possible to have hundreds of trades executed in a minute, and one trader could make as many as 20 trades at several different execution prices within that minute. To the extent that the audit trail does not precisely identify when orders are received, executed, and moved off the trading floor, an opportunity exists for dishonest floor participants to violate trading rules without detection and to get a better price for themselves or others at the expense of customers and other traders.

EXCHANGES' PLANNED AUTOMATION INITIATIVES HAVE POTENTIAL TO BETTER DETECT OR PREVENT TRADE ABUSES

The Chicago Board of Trade and the Chicago Mercantile Exchange are developing automated order routing systems and researching the use of hand-held trading terminals to improve the operational efficiency and integrity of their open-outcry trading process. The exchanges also are developing automated trading systems that will be used instead of the open-outcry trading process for after-hours trading. To varying degrees, we found that each planned initiative could provide more accurate trade records to better detect certain abuses, and automated trading systems could also prevent some abuses. These systems are still in the planning stage; the extent to which the exchanges will maximize the use of available technology to control trade practice abuses is, therefore, not certain.

Automated Order Routing Systems Can Provide Limited Information To Better Detect Abuses on the Open-outcry System

The exchanges are developing automated order routing systems to (1) enable member firms to send orders electronically to exchange floors for delivery to their designated brokers, and (2) report executed orders electronically back to member firms and to clearing organizations for further processing.

The planned Chicago Board of Trade system is currently being pilot tested by two member firms during the exchange's evening trading session. The planned Chicago Mercantile Exchange system is scheduled to be piloted in October 1989.

At the close of our review, the exchanges were considering the development of a common interface to these systems to provide member firms with standard formats to route orders to either exchange from a single terminal.

These systems are intended to get customer orders to and from the exchanges' trading floors more quickly, and would eliminate the need to manually time-stamp and route such orders into and from the exchanges. The systems are being designed to (1) automatically record to within a hundredth of a second the times orders enter exchanges and (2) accurately record the times that filled orders leave the exchanges. Officials from both exchanges believe that this improved timing data should increase the accuracy of the audit trail, facilitate the detection of abuses, and, therefore, act as a deterrent to trading violations.

The extent to which planned automated order routing systems will facilitate the detection of trading abuses is, however, unknown. Use of these systems by member firms is planned to be optional, and other alternatives will continue to exist for member firms to route customer orders to the exchanges. As a result, the potential benefits provided by the systems may not be fully realized, and exchange officials were unable to estimate the percentage of orders that would flow through these systems. Also, current exchange audit trail systems will have to be modified to accept and analyze the improved electronic timing data. Although exchange officials said that audit trail system modifications will be made to accept the improved timing data, the extent of and schedule for such modification has not been determined. In addition, these systems will only provide improved timing data for customer orders and cannot be used to determine the timing and sequence of trades generated by floor traders for their own personal accounts.

Hand-Held Trading Terminals Hold Promise To Detect Trading Abuses

The Chicago futures exchanges are researching systems that use hand-held trading terminals to improve the efficiency and integrity of trade timing data. In recent years, these devices have been explored for use on the trading floors to allow floor participants to enter information on executed trades for recordkeeping, audit trail, clearing, and price reporting purposes. However, on August 16, 1989, the two exchanges announced renewed efforts to expedite research and development of an electronic audit trail system. The system is intended to include stationary broker workstations that can be used to receive incoming orders from exchanges' planned order routing systems, and hand-held trading devices to more accurately track trade execution times in each trading pit. Overall, the Commission and exchange officials expect that such devices should automatically generate and document more precise trade timing data and make it more difficult for market participants to manipulate trade reporting to conceal abuses.

An August 1985 Commission report[6] concluded that "off-the-shelf" trade timing devices did not exist to meet the exchanges' requirements, but that a cost-effective, nondisruptive trade timing device could be engineered by using various components found in available retail products. Until recently, the exchanges believed that technological concerns such as problems with communications and ease of use prevented implementation of a device that would not require fundamental changes to their open-outcry process. Their renewed research is intended to focus on the (1) transmission technology that will automatically transfer trade data from the hand-held terminals to exchange-operated central computers and clearinghouses, and (2) input technology that will allow traders to quickly enter their trades on hand-held terminals. Transmission mediums being considered include radio and infrared signals. Input methods planned to be researched include various forms of programmable key, touch screen, and handwriting and voice recognition technologies.

Since the Chicago futures exchanges have not selected the specific capabilities and technologies for the stationary broker workstations and hand-held trading terminals, they had no specific information on how such devices would interface with the open-outcry trading process. Consequently, we could not assess the devices' capabilities to detect or deter trade practice abuses. However, various alternatives exist that could be used in implementing such systems. For example, one alternative could require all orders to be electronically delivered to trading floor participants, while another could permit both electronic and manual delivery of orders to floor participants. If the systems are not required to be consistently used by trading floor participants, the improved trade timing data provided by these technologies will not be fully realized.

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[6] AUDIT TRAIL PROPOSAL: Research on Selected Technological Alternatives, August 14, 1985.

Automated Trading Systems Could Better Control Some Trade Practice Abuses

Automated trading systems that would allow futures trading outside normal trading hours are now under development by both the Chicago Board of Trade and the Chicago Mercantile Exchange.[7] These systems are being designed to be used instead of the exchanges' trading floors for such after-hours trading and are planned to have features that can be used to prevent some abuses and provide an accurate audit trail of all systems' transactions, so as to better detect others. Although both exchanges are designing systems with different features, each believes that its system will be able to control how and when trades are executed, and will have the capability to record trading activity to within a hundredth of a second. Exchange officials believe that with this degree of accuracy in recordkeeping, investigators should be able to better identify various trade relationships and patterns that indicate trade practice abuses. Our review of the preliminary systems designs supports these views. In addition, this general opinion that automated systems can be designed to prevent and detect trade practice abuses is supported by officials of six foreign futures exchanges that use or plan to use automated futures trading systems.

Officials of the Chicago and foreign futures exchanges cited the following examples of potential benefits of automated trading systems to prevent and detect trading abuses:

-- These systems can prevent an abuse called "curb trading."[8] Specifically, officials representing the two Chicago and most foreign exchanges said that curb trading will not occur because automated trading systems will not allow trades outside the exchanges' set trading periods.

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[7] The planned Chicago Board of Trade system, called Aurora, is intended to electronically simulate pit trading by providing icons that identify traders on a screen. The planned Chicago Mercantile Exchange system, called Globex, is intended to electronically match buy and sell orders. During our review, the two exchanges were discussing possibly merging these systems into one.

[8] Curb trading is the trading that takes place after the official market has closed.

- These systems can be designed to require that all trades be presented to a competitive marketplace for execution, and that all executed trades have prices at or within the existing bid and offer spreads. Troublesome trading abuses within the open-outcry trading process involve instances where trades are noncompetitively executed and where customers receive worse prices than the existing best bids and offers. These abuses may include certain types of cross trading and bucketing.[9]

- These systems offer the potential to provide investigators with better audit trail information to detect trading abuses by providing more accurate and complete information on all bids, offers, and executions.

The benefits that can be derived from the more accurate and complete information that an automated system can provide depend on how the exchanges decide to use such information. Because these systems have yet to be fully designed and implemented, we could not assess whether the exchanges will fully utilize their systems to control trade practice abuses. Additionally, Chicago and foreign exchange officials agree that automated systems are not a panacea to eradicate all types of trading abuses. For example, an official of a foreign exchange said that although automated trading systems can be designed so that all bids and offers must be separately entered into the competitive marketplace, automated trading systems cannot prevent collusion by brokers who make trading arrangements before associated bids and offers enter the system.

GENERIC RISKS ASSOCIATED WITH AUTOMATION

Automated systems such as those planned by the Chicago Board of Trade and the Chicago Mercantile Exchange introduce risks that must be controlled to ensure that they do not reduce each exchange's ability to provide efficient, fair, and equitable treatment to all market participants. Although not meant to be all inclusive, the following list identifies some generic risks that need to be addressed:

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[9] Cross trading is an abuse where there is a noncompetitive match of the buy order of one customer against the sell order of another. Bucketing is defined as directly or indirectly taking the opposite side of a customer's order into the broker's own account or into an account in which the broker has an interest, without competitive execution of the order on an exchange.

- Correct processing: the need to ensure that the system hardware, software, and communications perform as intended. Risks include errors that cause orders to be processed incorrectly, or participants to receive privileged treatment.

- Responsive operations: the need to ensure that the system is properly sized and designed to support timely operations under normal and high-volume conditions. Risks include an inefficient system design and inadequate transmission, processing, and storage capacities.

- Secure operations: the need for established controls to prevent unauthorized access and the misuse of automated systems. Unauthorized access concerns include the failure to establish controls over who can enter the computer system processing area, who can use the system, and who can access the information contained in the system. Misuse of automated systems includes disabling system controls, erasing audit trails, and accessing system information in an unauthorized fashion.

- Continuous service: the need to ensure service to users in the event of equipment and software failures, natural disasters, and intentional malicious acts. Risks include a lack of contingency plans to ensure that systems could conduct normal operations under conditions such as floods, fires, etc.

Officials from both exchanges stated that they are aware of these risks and are actively taking steps to mitigate their adverse effects. As agreed with your office, given the time constraints of this review and the uncertainty associated with the exchanges' plans to merge their after-hours trading systems, we have not assessed their progress in these areas.

THE COMMISSION SHOULD ENSURE THAT AUTOMATED SYSTEMS CONTROL POTENTIAL TRADING ABUSES AND RISKS

Congress created the Commodity Futures Trading Commission in 1974 and gave it the authority to regulate commodity futures and related trading in the United States. In this role, the Commission is responsible for ensuring the economic utility of futures markets by encouraging their competitiveness and efficiency, safeguarding their integrity, and protecting market participants against manipulation, abusive trade practices, and fraud in the marketplace. As the futures markets become increasingly dependent upon automation, it is important that technical reviews of exchanges' automated systems be conducted to (1) assess each system's ability to prevent or better detect trade practice abuses and (2) ensure that the risks associated with the introduction of an automated system do not diminish an exchange's competitiveness, efficiency, and integrity.

For example, the Commission approved the Chicago Mercantile Exchange's planned after-hours trading system on February 2, 1989. This approval included a review of the exchange's requested rule changes[10] for the system, and the exchange's responses to questions by the Commission on certain system functions. However, this approval did not include a detailed independent assessment of technological alternatives available to prevent or detect trade practice abuses, and the risks associated with the system.

During the course of our review, Commission officials questioned the need to technically assess exchanges' automated systems because they believed that the exchanges have a vested interest in developing sound systems, and said the Commission lacked sufficient resources for detailed technical assessments of exchanges' automated systems. Although the exchanges are responsible for providing reasonable assurance that automated systems they introduce to their trading processes are reliable and properly safeguarded, the Commission has a similar role because of its responsibility to regulate commodity futures trading and to ensure the integrity, efficiency, and effectiveness of the futures markets. Commission officials later said that our review had increased their receptiveness to taking a more active role in reviewing the technical capabilities of exchanges' planned automated systems. For example, the Commission has contacted other government agencies in an attempt to better understand the automation issues that should be included in technology assessments.

Commission officials said that such technical assessments of exchanges' systems would be performed by personnel within their Office of Information Resources Management. The Office is responsible for the Commission's internal data-processing operations. However, the extent to which the Office can perform such assessments is unclear because the Commission has not allocated resources to the Office for these activities, and has not established guidelines for conducting them.

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[10] Rules are the principles for governing an exchange. Exchanges are required to submit all rule changes and new rules to the Commission for review.

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We discussed the contents of this report with senior officials of the Commodity Futures Trading Commission, the Chicago Board of Trade, and the Chicago Mercantile Exchange, who generally agreed with the accuracy of the information presented. We have incorporated their comments in the report as appropriate.

We are providing copies of this report to other interested members of Congress, executive branch agencies, and the public. We will also make copies available to others upon request.

This work was performed under the direction of Howard G. Rhile, Director, General Government Information Systems, who can be reached at (202) 275-3455. Other major contributors are listed in appendix III.

Ralph V. Carlone

Ralph V. Carlone
Assistant Comptroller General

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INFORMATION ON THE OPEN-OUTCRY TRADING PROCESS ON CHICAGO FUTURES EXCHANGES

At the Chicago Board of Trade and the Chicago Mercantile Exchange, futures contracts and options on futures contracts are traded at centralized trading floor locations, called trading pits. Each futures or options product is assigned one trading pit, so that all market activity is concentrated in one centralized location. The exchanges use an open-outcry system wherein traders verbally or through hand signals make bids and offers to each other. Market participants in the pits are called floor brokers and floor traders. Floor brokers trade for others while floor traders trade strictly for themselves. Floor brokers can be referred to as "dual traders" if they trade for customers and themselves during the same day in the same contract.

To place an order, a customer typically contacts an account executive of a clearing member firm, referred to as a futures commission merchant.[1] If the futures commission merchant is not a clearing member of an exchange, then the order is transmitted to a clearing member at which the non-clearing firm has an account. The account executive prepares and time-stamps an office order ticket. The order is then transmitted to a trading booth on the exchange trading floor by telephone or automated computer transmission. Upon receipt of the order, a clearing member's order clerk prepares a floor ticket and time-stamps it. A clerk then hand-signals the order or sends a runner with the order ticket to the floor broker or his or her assistant at the rim of the pit. The hand signals or order ticket indicate to the floor broker the quantity, price, and type of futures contract to buy or sell. The floor broker executes the customer's order by offering or bidding it to other traders verbally and through hand signals. If accepted, the broker and opposite trader confirm the trade. The broker records it on a floor order ticket or trade card. Both participants in the trade (buyer and seller) are required to report the price to exchange price reporters and to verify that the price is reported accurately. The floor order ticket is returned to the trading booth, where it is time-stamped and the transaction reported to the futures commission merchant, who records the price on the office order ticket. The customer must receive written confirmation of the executed trade by the next day, but may also receive telephone confirmation that same day.

Personal trades of both brokers and traders executed by themselves do not require order tickets, but are required to be recorded on trading cards. These cards include the trader's name or code, the clearing member, the date, the time period (i.e., half-hour bracket or minute, depending on the type of trade), the commodity, the month, the quantity bought or sold, the execution price, and the opposite floor broker or floor trader designation and opposite firm.

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[1] The futures commission merchants are generally equivalent to securities broker dealer firms.

On the exchange floor, clearing firms collect order tickets and trading cards, record available trade data, and transmit the data to the exchange clearinghouse. The clearinghouse matches the buyer and seller reports of each trade and reports discrepancies, known as out-trades, to clearing firms, which are required to reconcile them.

The open-outcry trading process used at the Chicago Board of Trade and the Chicago Mercantile Exchange is dependent on a variety of handwritten records of orders and trades. Information from these manually prepared records, in conjunction with the exchange's trade price recording system, is used later by the exchanges in computerized trade-reconstruction systems to derive execution times for trades to within 1 minute. These execution times are later used by the exchanges and the Commission in automated surveillance systems to assist investigations of trade practice abuses.

Trade practice abuses include various techniques to avoid competitive order execution. By avoiding competition, floor participants may secure a better transaction price at the expense of other market participants, including customers and other traders. The following list, from our March 1989 report,[2] includes the major trade practice abuses that the Commission and exchanges try to detect. The abuses are not mutually exclusive, and some of the definitions partially overlap.

-- Prearranged trading: agreeing to some aspect of a transaction before it is openly executed on the exchange floor.

-- Accommodation trading: entering transactions to assist another floor participant in accomplishing improper trading objectives.

-- Trading ahead of customer orders: trading for one's personal account or an account in which one has an interest, while having in hand any executable customer order in that contract.

-- Bucketing: failing to introduce an order to the marketplace, traditionally occurring when a broker noncompetitively takes the other side of a customer order to the detriment of the customer or other members.

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[2] GAO/GGD-89-58, Mar. 13, 1989.

-- Wash trading: entering or purporting to enter into transactions to provide the appearance of trading activity without resulting in a change in market position.

-- Curb trading: trading after the official close of trading.

-- Cross-trading: matching customer orders without offering them competitively.[3]

Exchange rules also preclude disclosing customer orders except to the exchange or Commission, and allocating the best trades to one's own account or to that of preferred customers.

In some cases, no direct harm may result to customers. However, unscrupulous traders also combine these and other abuses in complex schemes designed to cheat customers by circumventing the open-outcry system. Commission and exchange officials consider the most serious abuses to be those that give customers less advantageous prices than orders competitively executed.

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[3] Crossing the orders of two customers is generally permitted, provided the broker first offers the orders competitively and meets certain other regulatory requirements.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to provide information on the (1) potential benefits in using automated systems planned by the Chicago Board of Trade and Chicago Mercantile Exchange to detect or prevent trade practice abuses, (2) potential vulnerabilities associated with using automated systems in conjunction with or in place of the current open-outcry trading process, and (3) Commodity Futures Trading Commission's oversight role in reviewing automated exchange systems.

In conducting our work, we reviewed available systems' related documentation and interviewed officials at the Commodity Futures Trading Commission in Washington, D.C., and Chicago, Illinois, and the Chicago Board of Trade and the Chicago Mercantile Exchange on the operations and potential capabilities of automated order routing and handling systems, hand-held trading terminals, and automated trading systems to detect or prevent trade practice abuses. We also obtained information from officials of six foreign exchanges that use or plan to use automated futures trading systems, in Auckland, New Zealand; London, England; Sydney, Australia; Tokyo, Japan (2); and Zurich, Switzerland.

To identify vulnerabilities associated with automated systems, we met with officials of both Chicago futures exchanges and the Commission, and reviewed and analyzed relevant federal and private-sector information resources management publications to document generic concerns associated with using automated means to conduct futures trading.

We also interviewed officials of the Commodity Futures Trading Commission and obtained and reviewed supporting documentation of the Commission's role in assessing automated systems being developed and used by the futures exchanges. We examined the Commission's role in reviewing the Chicago Mercantile Exchange's planned after-hours trading system, including its report[1] that supported the Commission's approval of the system. We reviewed the Commission's AUDIT TRAIL PROPOSAL: Research on Selected Technological Alternatives, dated August 14, 1985, to assess the Commission's role in reviewing hand-held devices. We also reviewed the Commission's rule-enforcement reviews of the Chicago Mercantile Exchange and Chicago Board of Trade, dated September 27, 1988, and February 17, 1989, respectively, to assess its role in reviewing exchanges' audit trail and surveillance systems.

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[1] Chicago Mercantile Exchange's Proposed Globex Trading System, February 2, 1989.

Our work was performed from March 1989 through August 1989, in accordance with generally accepted government auditing standards.

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TESTIMONY OF KALO A. HINEMAN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY OF THE UNITED STATES SENATE

SEPTEMBER 8, 1989

Mr. Chairman, I am pleased to be here today to discuss the findings of the Commodity Futures Trading Commission's review of the Chicago Board of Trade's emergency action that ordered the liquidation of the largest positions in the July 1989 soybean futures contract. Chairman Gramm asked me to convey to you her regrets that she is unable to be with you today because of a prior commitment to meet with the international regulators of futures and options markets.

As a Commissioner with lifelong involvement in the agricultural sector, I am pleased to have the opportunity to report to you our findings regarding a self-regulatory action that has been viewed in some quarters with a considerable degree of mistrust and confusion.

After the close of trading on July 11, 1989, the Board of Directors of the Chicago Board of Trade met and voted 16 to 1 to take an emergency action regarding the July 1989 soybean future. (Appendix 1). That emergency order required any person who owned or controlled a gross long or short position in the July soybean future exceeding 3 million bushels to liquidate that position by at least 20% per day. By the close of trading on July 18, 1989, no person could have a gross long or short position exceeding 3 million bushels, and by the close on the contract's final trading day, July 20, no trader could have a position exceeding 1 million bushels.

We believe the coordinated market surveillance efforts of the Commission and the Exchange were performed diligently and properly. We faced a serious market problem that, if ignored or treated too timidly, most likely would have led to severely distorted July soybean futures prices and could have resulted in contract defaults. These prospects were recognized early by both the Commission and the Exchange. We both applied a full range of informal surveillance measures, increasing in intensity, before resorting to more formal measures on July 11.

Extensive and frequent information sharing and high level consultation between the Commission and the Chicago Board of Trade occurred through the point where the Exchange determined that an emergency action was needed to assure an orderly liquidation of the July soybean contract. That decision clearly was an extraordinary event. However, it is one that is countenanced by exchange and Commission rules. It is the most difficult exercise of an exchange's self-regulatory obligations under the Commodity Exchange Act in the market surveillance area. In our view, the Exchange declared the emergency because they decided in the face of a recognized market threat that the risks to the integrity of the soybean futures market and to the Exchange itself were greater if they failed to act decisively than if they acted directly against that threat.

We were fully aware of the events leading to this market emergency. The Commission carefully has reviewed the market situation and the exchange's action to address it, as it does all exchange emergency actions. A significant part of that review addresses the question of whether the Board members who voted on the action abused their authority to favor their own self-interest. The integrity of the persons undertaking such an action is critical to public confidence in the ability of a membership organization to exercise effectively its self-regulatory responsibilities. We conducted a thorough review of the actions taken by the Board to insulate the Exchange's action from abuse and of the Board members' potential interests in the July 1989 soybean future. We found no evidence of conflicts of interest or misuse of confidential information by Board or Committee members.

It is noteworthy in this regard that the Board's vote to take the emergency action passed by a overwhelming margin of 16 to 1, well above the two-thirds vote necessary to approve the emergency order. No individual member's vote, therefore, was decisive in the approval of the emergency rule. None of the directors voting on this action owned or controlled a position in the July soybean future. Furthermore, although some directors were affiliated with firms that had house or customer positions in that contract, 11 of the 16 voting "Aye" had no affiliated firm positions or had no affiliations. There is nothing in the record to support the notion that an interested member tipped the balance in his or her favor or in favor of another member to the detriment of the public.

Let me now describe in more detail our involvement in the surveillance of the July 1989 soybean future and how we reached our conclusions about the various aspects of the Exchange's emergency action.

Basis for the Emergency

The Chicago Board of Trade's emergency order was the culmination of a long and arduous market surveillance process covering several grain and soybean-complex futures contracts for a number of months prior to July 1989. The Commission's surveillance staff closely monitored these markets and the CBT's surveillance activities during this period. We believed then, and do now, that the Exchange was employing appropriately measured surveillance steps which ultimately led to the emergency action. The absence of voluntary liquidation by the major long in the July soybean market, a group of subsidiaries of Ferruzzi Finanziaria S.p.A. ("the Ferruzzi Group"), was a significant factor in the Exchange's decision to take emergency action to force the liquidation of positions that posed a threat to the orderly liquidation of that future.

By July 11, 1989, a number of facts were known to both the Exchange and the Commission that provided ample basis for finding that a threat to the orderly liquidation of the July 1989 soybean future existed:

-- Open interest was unusually large and was being liquidated at an unusually slow pace. On July 10, 1989, open interest in the July future was over 40 million bushels, as compared to a range of 8 million to 26 million in the prior five years at the same point in the July expiration. (Appendix 2).

-- The available supply of soybeans was low, due in large part to the drought of 1988. Total U.S. ending stocks were projected to be the lowest in over a decade, and total stocks in deliverable position were less than 13 million bushels.

-- Both the long side of the July contract and the supply of deliverable soybeans were held, in large proportions, by the same trader. On July 11 the Ferruzzi Group held a gross long position that controlled nearly 60% of the open interest in the July future (Appendix 3) while it also owned at least 60% of all the soybeans in deliverable locations. The Ferruzzi long July futures position was over twice as large as the total stocks registered by the CBT as deliverable and over four times larger than the total remaining stocks in deliverable locations that it did not already own.

-- The July futures price was unusually high relative to other months and to alternative sources of soybeans for domestic processing or export. For example, on July 10 the July contract was priced more than 40 cents higher than the August future, the largest July premium since 1973. (Appendix 4). Various cash markets appear to have been lower-priced sources of soybeans than was the July future. For example, in early July barge bids at the Gulf were quoted at about 12 cents over the July futures price. Since it would cost about 30 cents over the July future to ship soybeans from Chicago to the Gulf, taking delivery on the July futures appeared to be an uneconomic source of supply for Gulf exports. The same analysis applies for domestic soybean processing. Even Ferruzzi, who claimed a large commercial need for soybeans in July, was bidding less than delivery value in the cash market.

-- The Ferruzzi long futures position was significantly larger than any other long or short position in the July soybean future. More importantly, while others were significantly reducing their positions between June 29 and July 11, the Ferruzzi Group was not. (Appendices 5 and 6).

-- Both the CBT and the CFTC, through a series of verbal and written communications and warnings, had made it clear to the Ferruzzi Group since at least late May that it could not stand for delivery on a major portion of its July soybean futures position without causing a disorderly liquidation. (Appendix 7).

Thus, when the CBT's Board of Directors met on July 11, they knew that the open interest was far greater and the July-August futures price inverse was much larger than had existed at comparable points in time for at least the last decade; the majority of stocks in deliverable position were held by the largest long futures trader; and that same long trader held July futures that represented nearly 60 percent of the open interest. The CBT also concluded that Ferruzzi was not bidding aggressively to acquire beans in the cash market and was not responding to directives from the Business Conduct Committee (BCC) to begin substantial reductions of its position. Ferruzzi, as is evidenced by its July 10 letter to the BCC, was not committing itself to liquidating a significant portion of its large long position according to any specific terms or schedule in the seven remaining trading days. (Appendix 7).

Based on these facts and assessments, the CBT determined that an emergency order was necessary to assure the orderly liquidation of the July contract. The Commission's review of these facts, supported by our own surveillance experience, leads us to conclude that the Chicago Board of Trade had a reasonable basis for determining that a market emergency existed that threatened the orderly liquidation of the July 1989 soybean futures contract.

CFTC Involvement

The CFTC was actively involved in the surveillance of the July soybean future. We believe the consultation and information-sharing between the Exchange and Commission staffs in this matter was excellent. However, the Chicago Board of Trade made its own decisions regarding the sequence and nature of the actions it took.

The CFTC had closely monitored the liquidation of the July future for several weeks, with regard to both the activities of the major traders and the surveillance and regulatory activities of the Exchange. CFTC staff were in frequent contact with appropriate Exchange staff, with whom we shared information on market developments and exchanged views about the progress of the liquidation. CFTC staff closely followed the status of the Exchange's surveillance of this future to ensure that the Exchange would fulfill its responsibility to maintain fair and orderly trading. The Commission was kept informed of the progress of the liquidation and of Exchange initiatives at its weekly surveillance briefings.

Both the Exchange and the CFTC pursued a series of gradually escalated informal measures and private communications to market participants -- both longs and shorts -- to resolve the potential problem in the July future. For example, CFTC staff were in nearly daily contact with Ferruzzi representatives from May through July to evaluate and monitor their need for soybeans, their ownership of supplies in deliverable locations and their July futures position. (Appendix 8) Through these telephone and personal contacts the staff repeatedly advised the Ferruzzi representatives prior to July 11 that they were expected to reduce their futures position to avoid a disorderly liquidation of the July contract. These informal measures have been used successfully in the past, including during the May soybean futures expiration. In this case, however, these informal measures failed to resolve the problem.

A brief summary of the specific actions taken prior to the CBT's emergency order on the evening of July 11 will illustrate the role we played and our evaluation of events that led to the emergency order.

The CBT's BCC invited representatives of Ferruzzi to appear before it on the afternoon of Wednesday July 5. The CFTC and CBT surveillance staffs conferred before and after that meeting to be sure both had the most current information and both understood the message being conveyed to Ferruzzi. On the next day, July 6, Ferruzzi representatives spent several hours with CFTC Chicago surveillance staff, explaining their cash and futures market positions. The CFTC staff urged Ferruzzi to liquidate its July futures position and buy any soybeans they needed in the cash market since cash prices appeared to offer a cheaper source of soybeans. The CFTC staff also advised Ferruzzi that the staff was considering a recommendation to the Commission to revoke Ferruzzi's hedge exemption in the July future for anticipated processing requirements.

On Friday July 7, the BCC sent a strong warning letter to Ferruzzi. That letter stated that on July 5 the BCC had requested Ferruzzi "to reduce its position immediately and aggressively by all means including but not limited to aggressively buying in the cash market for soybeans and liquidating its long July position..." The letter expressed dismay at the lack of liquidation to date and strongly urged daily liquidation of at least three million bushels a day. If substantial liquidation was not accomplished by July 10, the BCC told Ferruzzi that it would ask the Board of Directors to take emergency action to ensure an orderly liquidation of the contract. (Appendix 7).

Also on Friday July 7, the Commissioners were briefed extensively on soybeans by the Market Surveillance staff, as they had been at regular surveillance briefing for several months. The staff summarized market developments and Exchange actions to date and advised the Commission of the staff's continuing concern about the contract. The staff recommended that the Commission curtail the hedge exemption of Ferruzzi during the final trading days of the July and August soybean futures by not considering as bona fide hedging any long futures positions held against anticipated processing requirements. Staff documents effectuating this recommendation were prepared after the meeting, and, upon formal Commission approval, were sent via facsimile transmission on the morning of July 11. (Appendix 7).

On Monday July 10, the BCC received a reply letter from Ferruzzi to the BCC's letter of July 7. In that letter Ferruzzi professed that it had been cooperative, but indicated that it might stand for delivery on its long July futures position and that it might seek to recover damages from the CBT should an Exchange action prevent it from doing so. (Appendix 7)

The CBT gave a copy of this letter to CFTC staff that same day. After the close of trading on July 10, the BCC met. They considered the letter and the fact that Ferruzzi had reduced its long position in July soybeans only slightly since meeting with the BCC on July 5. The BCC decided to recommend that the Board of Directors consider taking emergency action to order a liquidation of positions in July soybeans.

After that BCC meeting, the Chairman of the Board of Directors telephoned Chairman Gramm, advising her of the recommendation and asking whether the CFTC had any advice regarding alternative actions. Chairman Gramm had previously discussed the soybean situation with Chairman Mahlmann during the prior week. Also after the BCC meeting, a senior CBT officer contacted the CFTC Director of Market Surveillance to discuss the same matter. Chairman Gramm met with staff about the soybean situation that evening and again the following morning. At the morning meeting the staff presented five alternative emergency actions that appeared to be appropriate in these particular circumstances. (Appendix 9). Chairman Gramm telephoned Chairman Mahlmann in the morning on July 11 to discuss the matter further. Also that morning the senior CFTC staff sent a copy of those alternatives to senior CBT staff along with a copy of the Commission's letter to Ferruzzi.

In these conversations on July 10 and 11, the Commission and its staff did not instruct the CBT to declare an emergency. Nor did we tell them not to. We shared their conclusion that firm action was called for to ensure an orderly liquidation. In fact, the Commission's July 11 letter curtailing the Ferruzzi hedge exemption was intended as a firm measure that would require Ferruzzi to liquidate or roll forward to deferred futures months most of its long July futures positions prior to July 18.

The Commission believed that the Exchange was performing its surveillance responsibilities in a diligent manner. Therefore, the Commission saw no reason to question the judgment of the Exchange, based on their first-hand communications with the largest traders and their knowledge of their own market, in deciding whether the July future could liquidate properly without additional intervention. The Board of Directors decided on the evening of July 11 that voluntary measures had failed and that a formal emergency order was needed.

Responsibilities and Authorities of Exchanges

Market emergencies of this type certainly are rare, unpleasant events that frequently are hotly debated long after the situation giving rise to the action has passed. Nevertheless, it is important to remember that exchange emergency actions take place within the context of exchange rules that have been approved by the Commission as being in accordance with applicable Commission regulations and the requirements of the Commodity Exchange Act.

Emergency actions do not "change the rules in the middle of the game." Exchange emergency powers are part of the rules of the market from the outset to which each exchange member agrees to be subject. Their purpose is to keep the markets fair and competitive when some extraordinary threat to the integrity of the market emerges.

The wisdom and courage that an exchange displays in its use of its emergency powers may be viewed as an acid test of its self-regulatory competence. While it would be irresponsible for an exchange to use its emergency powers just to flex its self-regulatory muscle, it also would be irresponsible for an exchange to fail to use those powers when faced with a real threat.

Competent expert judgment is the critical element in an exchange's exercise of its self-regulatory responsibilities. The Commission is charged with reviewing the end product of that judgment as well as the procedures followed in reaching it.

Exchange emergency actions such as that taken by the CBT are governed by Section 5a(12) of the Act and Commission Regulation 1.41(f). These provisions permit exchanges to impose temporary rules for an initial period of 30 days without prior Commission approval in the event of an emergency, subject to certain procedural guidelines, including a proper finding of an emergency pursuant to exchange rules and approval by a two-thirds vote of the governing board. The CBT's emergency rules basically track Commission rules describing the circumstances that can constitute an emergency and the types of remedial actions that may be taken.

An exchange has great flexibility in taking an emergency action. It may address any situation that requires immediate action necessary or appropriate to an orderly liquidation or to preventing interference with the delivery process. The Commission, consistent with the provisions of Section 8a(9) of the Act, can take emergency action when it has reason to believe that there is a threatened or actual manipulation or corner or "other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand." These regulatory and statutory requirements for emergency action reflect the judgment that an exchange, as the authority closest to the market with access to information necessary for prompt action, is best suited to making an initial determination as to the appropriate action to take.

As demonstrated in this instance, exchanges and the Commission are in frequent contact when there is a concern regarding a contract liquidation. Exchanges are required to notify the Commission immediately after they declare an emergency. The Commission reviews all exchange emergency actions to ensure that they conform to the standards contained in the Commission's regulations and the exchange's rules. In each case, the contract market's determination that an emergency exists, as well as its choice of what remedial action to take, must not be (1) arbitrary, capricious, or an abuse of discretion, (2) lacking a reasonable basis in fact, or (3) taken in bad faith by the contract market or its officials. An exchange emergency action need not be the best action under the circumstances viewed from hindsight, but only an appropriate action at the time.

Consistent with its responsibilities in taking emergency action and meeting Commission requirements, the CBT has established rules and policies to ensure the integrity of the decision-making process by insulating such decision-making from actual conflicts of interest and preventing governing members from misusing information obtained as a result of the process. CBT policies require the scheduling of special Board meetings outside of trading hours, the polling of individual Board and BCC members as to their ownership or control of any positions relevant to the subject market, the recusal of Directors or BCC members who own or control such positions from participation in the deliberations or voting, and the protection from disclosure, to the extent possible, of specific positions of individual market participants.

Commission Review for Potential Conflict of Interest

The Commission has completed a careful and thorough review of the trading of each member of the Business Conduct Committee and the Board of Directors of the Chicago Board of Trade, as well as of firms affiliated with those members, to assess the issues of conflicts of interest and abuse of authority. That analysis revealed no evidence of conflict or abuse. We are providing a copy of our full analysis to the Committee. I will briefly summarize our findings.

The CBT has rules, regulations and procedures to ensure the integrity of its decision-making process, both with regard to the deliberations of the BCC and to special Board meetings called to consider emergency action. After its July 10 meeting, held after the soybean market closed, the BCC recommended that the Board take emergency action to ensure an orderly liquidation of the July 1989 contract. There were seven BCC members present and one absent at the July 10 meeting. Consistent with BCC rules and procedures, two members left the meeting prior to discussion of the July soybean expiration, one because he actively traded soybean futures despite having no personal position in the July future at the close on July 10, and the other because he had interests in several commodity pool accounts.

The July 11 meeting was the only Board meeting regarding July soybeans that occurred prior to the taking of emergency action. Notice of the meeting was posted at 1:15 p.m. CST, after the close of the soybean market, and the meeting was held at 2:15 p.m., providing the minimum advance notice permitted by CBT rules. Although the BCC had recommended that the Board take emergency action, except for the Chairman of the BCC who assisted in the drafting of the emergency rule, according to the CBT no other BCC member was aware whether the Board would declare an emergency or of the specific emergency action that might be taken. The decision of the Board was made public immediately following its meeting.

The only directors notified prior to the one-hour notice period were the CBT's three nonresident directors and three public directors. The only persons at the CBT aware of the recommended action prior to the Board meeting were the Chairman of the Board, the CBT's outside counsel, and four staff personnel, the President, General Counsel, Vice President of Administration and Planning, and a CBT staff attorney.

CBT employees are subject to Commission and Exchange prohibitions as to the disclosure of material, non-public information gained in their official capacity and an Exchange bar from trading. Commission Regulation 1.59(c) and CBT Regulation 188.01 also prohibit a Board or committee member from using or disclosing any material, non-public information obtained as a result of that member's participation on the Board or committee for any purpose other than the performance of his or her official duties as a governing member.

The CBT Board consists of 24 directors of which three are public and three are non-resident members. Initially, 20 directors were in attendance at the July 11 meeting, either physically present or in continuous telephonic communication. Prior to any deliberations, as documented in the minutes, the Chairman of the Board polled each director who was present to determine whether the director owned or controlled any position in July 1989 soybean futures. One director, who held a spread position in July soybeans, answered in the affirmative and, in accordance with standard procedures, recused himself from further participation in the meeting and departed. Nineteen directors then remained in attendance, including the President, Thomas R. Donovan, who is a non-voting member of the Board, and the Chairman, Karsten Mahlmann, who votes only to make or break a tie. As stated earlier, the Board adopted the emergency rule by a final vote of 16 "Aye" and one "Nay".

The Commission's review of trading activity prior to, during and after the emergency action revealed no CBT governing members who appeared to trade for the purpose of profiting personally, or through an affiliated firm, from prior knowledge of the July 11 order.

As of the close of soybean trading on the day of the vote, our review indicates that none of the participating directors owned or controlled positions in the July soybean future. Ten of the participating directors were affiliated with firms; four had no affiliated firm positions, while six participating members' affiliated firms carried net short positions for either their customers or in their house accounts. Of these six, two had both customer and house short positions, three had net short customer positions, and one had a net short house position and a long customer position. Of the three members affiliated with firms that had short house positions, one was the chairman, who did not vote.

Commission staff also reviewed the trading activity of Board and BCC members in July 1989 and other soybean futures during the period of July 3-12, and the customer and house positions of affiliated firms of Board and BCC members from June 26 to July 12, focusing on closing positions on July 10 and 11. This examination was conducted to determine whether any Board or BCC member, or his affiliate firm, traded in a manner that would indicate that either the member or the firm profited from any knowledge of the emergency order. The Commission staff's examination of trading records indicates no such trading activity. This review also confirmed that the one director who recused himself from the July 11 meeting was the only director carrying or controlling July 1989 soybeans.

Further, with regard to governing members' affiliated firms, Exchange staff has represented and Commission staff interviews have confirmed that the relationship of the participating CBT Board and BCC members to the affiliated firms carrying a position in their customer and/or house accounts is one of an official administrative nature, and entails no knowledge of or influence over the trading strategies of their affiliated firms. In fact, when the directors and BCC members are polled as to whether they "own or control" positions, the latter term is explained by CBT staff in this instance and as a general rule to include control of any customer or house positions at their affiliated firms.

The public policy of permitting traders to participate on an exchange governing board recognizes the contributions of their expertise and the interest and obligation of such board members in maintaining market integrity. The actions of exchange boards are governed by at least two key legal duties which must be balanced: their duty to manage the marketplace, and their duty to act in good faith.

These findings provide no evidence confirming the reported rumors and suspicions that any market participants, in particular Board and BCC members, traded on the basis of advance knowledge of the impending Board decision.

Effect on the Cash Market

We all have heard complaints that the Chicago Board of Trade's emergency action hurt soybean farmers by causing soybean prices to fall. On the first effective date of the action, July 12, the July future declined 39 1/2 cents per bushel, while the new crop November future fell only 13 cents. (Appendix 10). Cash prices at a number of locations fell by more than 30 cents per bushel that day. While a portion of the price declines in the July soybean future and in cash prices on July 12 may be an unfortunate side-effect of the emergency action, the more significant price slide in soybeans that began earlier in July before the emergency action and extended into early August, cannot be attributed to that event. Over that longer period the soybean market was reacting to more pervasive fundamental factors--particularly significant rainfall that greatly improved U.S. crop prospects and the increased movement of the large Brazilian soybean crop into the world market.

The CBT emergency action had a limited scope and effect. It began on July 12, and it terminated seven business days later with the expiration of the July future on July 20. The largest position liquidation occurred on the first day.

The emergency action did not extinguish any long hedges or any real demand for soybeans. All it did was rechannel that demand out of the July future and into the August, September, November or some other delivery month, and into the cash market. Both the CBT and the CFTC had been urging the Ferruzzi Group well before the emergency to raise its cash market bids at least to values comparable to the prevailing July future price, buy soybeans in the cash market, or roll its July futures positions into deferred delivery months.

A few facts will put the impact of the emergency action in a clearer perspective. Between July 5 and August 2, cash soybean prices at Decatur, Illinois fell about $1.50 per bushel. That price decline, however, cannot simply be attributed to the emergency action. Between July 5 and July 11, before the action was taken, the Decatur soybean price fell by 58 cents. While the Decatur cash price fell 38 cents on July 12, it rose over 20 cents from that point until July 20, the expiration date of the July future. From that date until August 2, the Decatur soybean price fell 75 3/4 cents per bushel. (Appendix 11). As the data and charts appended to this testimony illustrate, similar soybean price trends occurred at other locations during these same time intervals. (Appendices 12 and 13).

Clearly the largest price declines in cash markets for soybeans occurred before and after the period of the emergency action. At most, part of the price decline on July 12 could be attributed to that action, and most of that decline was recovered before the July contract expired.

A review of the close correlation between cash corn and soybean prices further illustrates this point. (Appendix 14). Between July 5 and 11, Central Illinois soybean prices declined 8.0% while Central Illinois corn prices declined 9.1%. (Appendix 11). Similarly, from July 12 through July 20, the period of the emergency action, Central Illinois soybean prices fell 1.6% while comparable corn prices fell 3.6%. Corn and soybeans were both affected by favorable weather during this period, but only soybeans was the subject of an emergency action. Yet, corn prices fell more on a relative basis than did soybean prices. (Appendix 15). This leads us to conclude that the emergency action had a minimal effect on prices to farmers when viewed from a perspective broader than one market on one day.

As a farmer, I fully understand that farmers have an interest in higher agricultural prices and are upset by falling prices. However, regulators -- both exchanges and the Commission -- must exercise their responsibilities to protect the integrity of markets in a price-neutral fashion.

Farmers also benefit from even-handed regulation that protects the futures markets from abuse. Had the CBT not acted in July and had July soybean futures prices been distorted upward as a result, farmers probably would not have benefited from that situation. And they may have been hurt.

Farmers would only benefit if they owned soybeans that could be moved to the Chicago or Toledo delivery points by July 30, the last day delivery notices could be issued. That is because a distorted futures price is a temporary, localized one that will not be sustained past the delivery period and will not extend to the entire cash market. Since most users of soybeans, anticipating a problem in the July future, had switched their bids to deferred delivery months well before the emergency action, their bids would not rise with a distorted July future. Furthermore, if a farmer or country elevator had a short hedge in the July future, they could have been doubly hurt. They would have to pay cash to margin their losing short futures position, but their stocks of soybeans would not rise in value by an equivalent amount. A distorted futures price would adversely affect their hedge.

Conclusion

Emergency actions, as the name suggests, properly are taken only under extraordinary circumstances. Market problems, in general, are better resolved through responsible voluntary action by market participants who respond appropriately to the market's economic signals. As you review the events of this past May through July, we believe you will find the regulators were engaged in diligent surveillance, appropriate levels of coordination, and forthright communication with each other and with market participants.

To the extent possible, both the exchanges and the CFTC try to avoid market intervention through emergency action. However, we believe that CBT action taken this summer was fully justified and was not flawed by conflicts of interest. In addition to defusing a very real threat to the orderly liquidation of the July soybean futures contract, the emergency action communicated to the industry that the regulatory authorities have the courage to take decisive action when the need arises. This action contributed significantly to the orderly liquidation of the August soybean future -- particularly by the Ferruzzi Group -- and may reduce the likelihood of future emergencies as well.

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2. CBT July Soybean Open Interest.

3. Percent of Open Interest Held by the Largest Long in the July 1989 Soybean Contract.

4. July/August Soybean Futures Spread.

5. Largest Long and Short Positions in July Soybean Futures on June 29 and Their Positions on July 11.

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12. Selected Soybean Cash Price Data.

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15A. Relative Price Changes of Decatur, ILL Cash Corn and Soybean

15B. Relative Price Changes of July 1989 Corn and Soybean Futures

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Chicago Board of Trade

APPENDIX 1

EMERGENCY RESOLUTION OF THE BOARD OF DIRECTORS OF THE BOARD OF TRADE OF THE CITY OF CHICAGO RELATING TO THE JULY 1989 SOYBEAN FUTURES CONTRACT; ADOPTED PURSUANT TO ASSOCIATION RULE 180.00 AND REGULATION 180.02, COMMODITY EXCHANGE ACT SECTION 5a(12), AND CFTC REGULATION 1.41(f).

RESOLVED, that the Board of Directors of the Board of Trade of the City of Chicago hereby determines that an emergency exists with regard to the July 1989 soybean futures contract traded on the Exchange that requires immediate action and threatens or may threaten fair and orderly trading in, the liquidation of, and delivery pursuant to, the July 1989 soybean futures contract, and hereby adopts the following measures to deal with this emergency:

> Effective as of the opening of the market on July 12, 1989, any person or entity, either alone or in conjunction with any other person or entity, who owns or controls a gross long or gross short position for any purpose whatsoever in excess of three million bushels in the July 1989 soybean futures contract traded on the Exchange must reduce said position and subsequent positions by at least 20% per trading day subject to the following absolute limits.
>
> No person or entity, either alone or in conjunction with any other person or entity, shall own or control a gross long or gross short position for any purpose whatsoever in the July 1989 soybean futures contract traded on the Exchange in excess of three million bushels as of the close of trading on Tuesday, July 18, 1989.
>
> No person or entity, either alone or in conjunction with any other person or entity, shall own or control a gross long or gross short position for any purpose whatsoever in the July 1989 soybean futures contract traded on the Exchange in excess of one million bushels as of the expiration of trading on Thursday, July 20, 1989.
>
> This resolution is applicable to all positions, whether hedge or speculative.

(2) Failure by any member or member firm to comply with this Emergency Resolution, or failure to assist in compliance with this emergency resolution including as directed by the Executive Committee pursuant to paragraph (3) below, shall be deemed to be an offense against the Association and an act detrimental to the interest and welfare of the Association.

LaSalle at Jackson
Chicago, Illinois 60604
312 435 3500

(3) The Executive Committee is authorized and empowered to take all steps it deems necessary in its sole discretion to assure compliance with this Emergency Resolution, including but not limited to the ordering of the liquidation on the Exchange (by brokers selected by the Committee in its discretion) of the July 1989 soybean futures position of any person or entity not in compliance with paragraph (1) above, to the extent of such noncompliance. The direction of the Executive Committee ordering liquidation on the Exchange shall be deemed for all purposes, including under the rules and regulations of the Association, to be the act of the person or entity whose position is being liquidated.

(4) Nothing in this Emergency Resolution shall be deemed in any way to preclude the Association from imposing sanctions on any member or member firm for any violation of Association rules or regulations, or this resolution, in connection with July 1989 soybean futures.

(5) This Emergency Resolution is expressly adopted pursuant to Association Rule 180.00 and Regulation 180.02, Section 5(a)(12) of the Commodity Exchange Act, and CFTC Regulation 1.41(f).

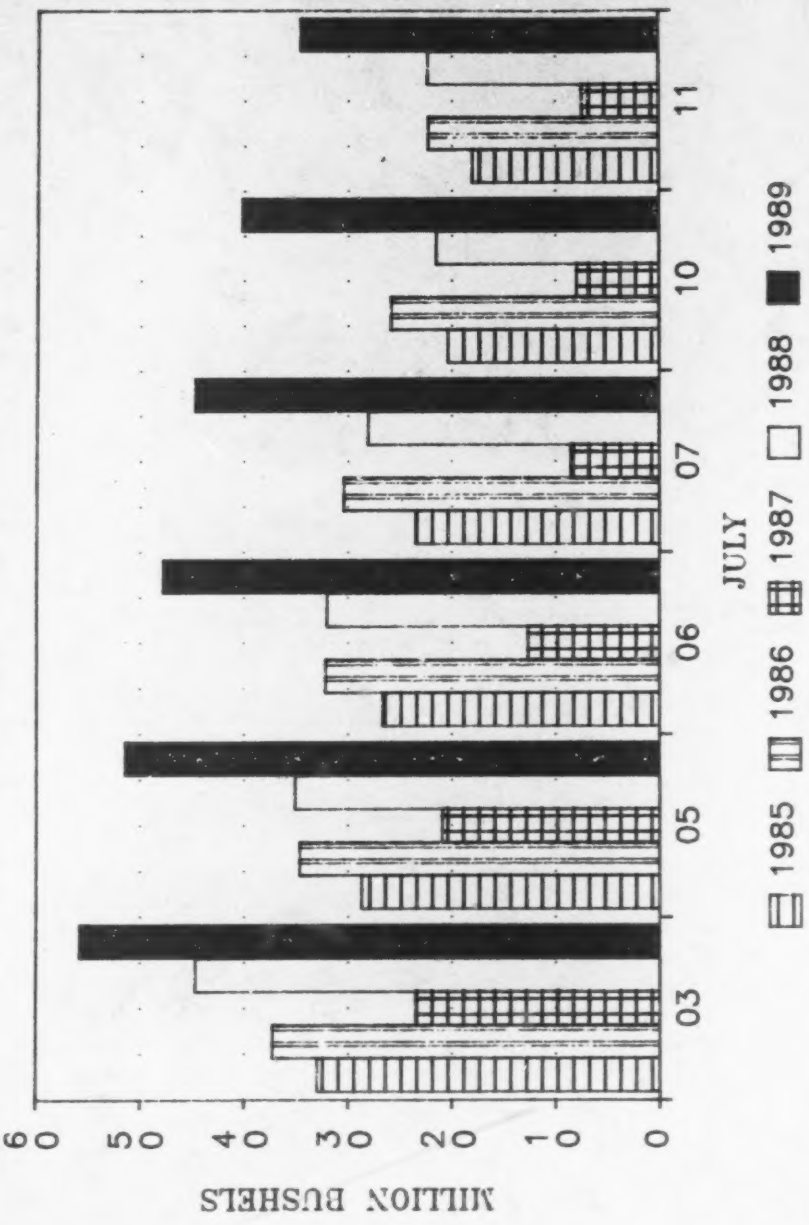
(6) Nothing herein shall be deemed to preclude the Business Conduct Committee or the Board of Directors from taking such further action, pursuant to the authorities referenced in paragraph (5) above or otherwise, as may be necessary in the Committee's or the Board's judgment to further provide for orderly trading and liquidation of July 1989 soybean futures and delivery pursuant thereto.

Date: July 11, 1989

Karsten Mahlmann

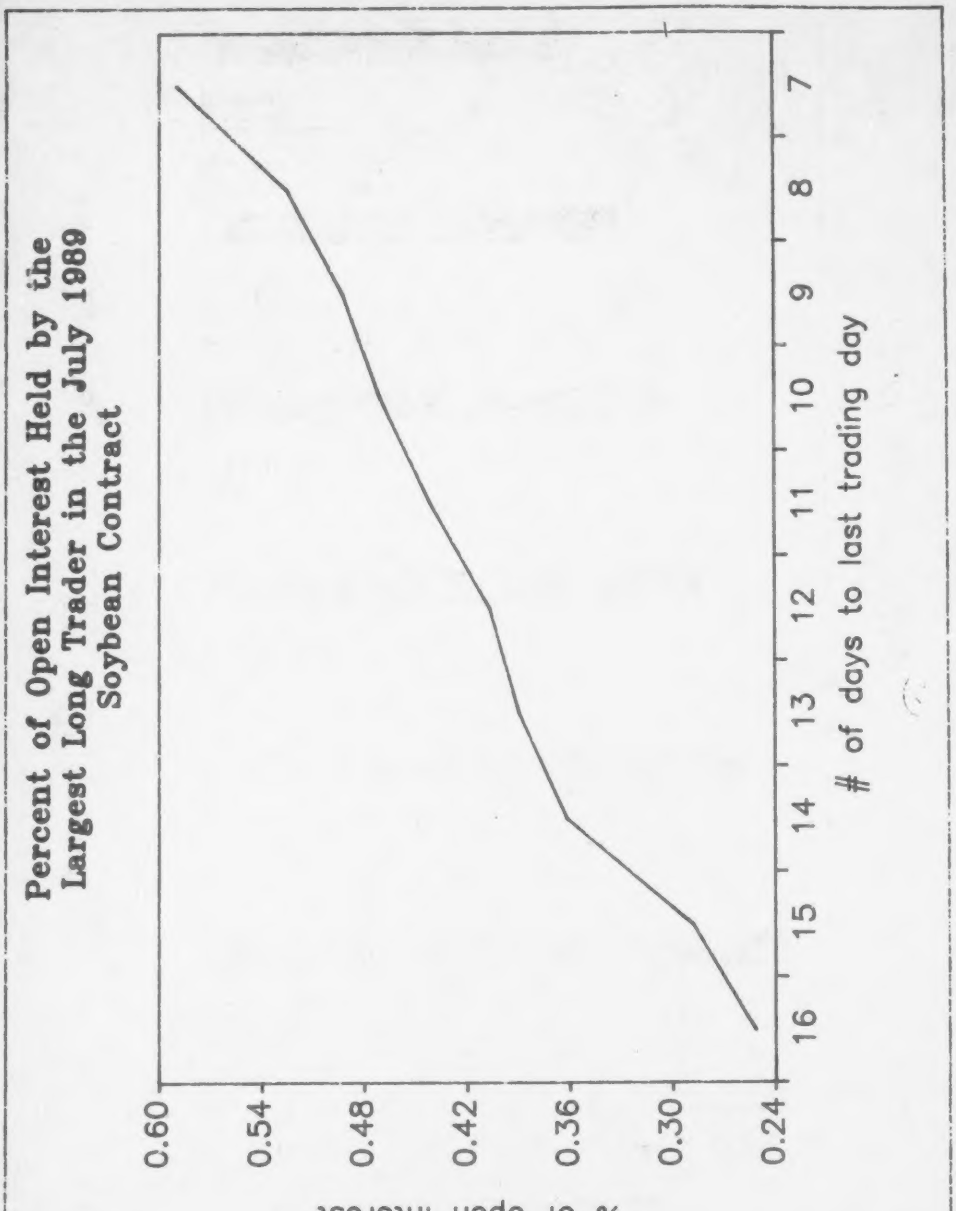
Karsten Mahlmann,
Chairman of the Board,
Board of Trade of the City
of Chicago

APPENDIX 2



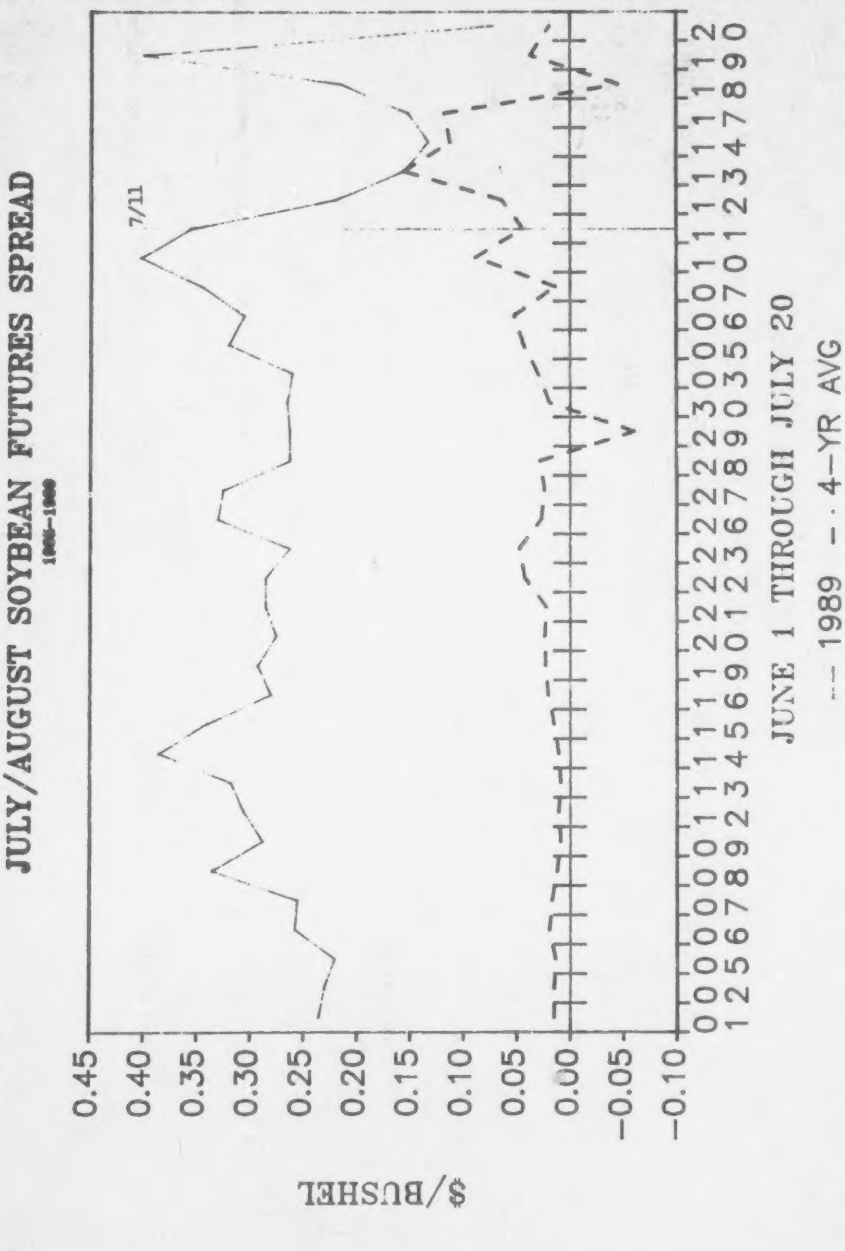
CBT JULY SOYBEAN OPEN INTEREST

APPENDIX 3



Percent of Open Interest Held by the Largest Long Trader in the July 1989 Soybean Contract
% of open interest
0.60
0.54
0.48
0.42
0.36
0.30
0.24
7
8
9
10
11
12
13
14
15
16
# of days to last trading day

APPENDIX 4



JULY/AUGUST SOYBEAN FUTURES SPREAD

1985-1989

4 YR AVG = 1985-1988

APPENDIX 5

TEN LARGEST TRADERS IN THE JULY 1989 SOYBEAN FUTURE ON JUNE 29, 1989 AND THEIR POSITIONS ON JULY 11, 1989 (IN THOUSAND BUSHELS)

		6/29/89 1/				7/11/89 2/			
		POSITION 4/		% OF OPEN INTEREST		POSITION		% OF OPEN INTEREST	
TRADER	TYPE 3/	LONG	SHORT	LONG	SHORT	LONG	SHORT	LONG	SHORT
A	C, F	23,240	1,435	36.1	2.2	20,475	1,735	59.0	5.0
B	C	0	9,585	0	14.9	0	3,910	0	11.3
C	C	0	3,645	0	5.7	0	1,540	0	4.4
D	C, F	3,215	2,530	5.0	3.9	1,880	1,870	5.4	5.4
E	N, F	2,750	0	4.3	0	NR	NR	-	-
F	N	2,425	0	3.8	0	175	0	0.5	0
G	C	0	2,410	0	3.7	0	260	0	0.7
H	C, F	0	2,305	0	3.6	NR	NR	-	-
I	C, F	0	1,700	0	2.6	0	380	0	1.1
J	N	1,620	0	2.5	0	2,095	0	6.0	0

	6/29/89	7/11/89
OPEN INTEREST	64,300,000 bu.	34,715,000 bu.
DELIVERABLE SUPPLY	13,100,000 bu.	13,000,000 bu.

1/ June 29, 1989 was the day prior to the first notice day of the July future.

2/ After the close of trading on July 11, 1989 the Chicago Board of Trade declared an emergency order on the July soybean future.

3/ Type indicators are: C = Commercial; N = Noncommercial; F = Foreign.

4/ Positions are in thousands of bushels. NR indicates that the trader does not hold a reportable position.

APPENDIX 6

ALL TRADERS HOLDING JULY 1989 SOYBEAN FUTURES POSITIONS ABOVE THE CFTC REPORTING LEVEL (500,000 bu.) ON JULY 11, 1989--RANKED BY LARGEST GROSS LONG OR SHORT
(POSITIONS IN THOUSAND BUSHELS)

TRADER	TYPE 1/	JULY FUTURES LONG	JULY FUTURES SHORT	% OF OPEN INTEREST LONG	% OF OPEN INTEREST SHORT	CASH POSITION 2/ LONG	CASH POSITION 2/ SHORT
A	C, F	20,475	1,735	59.0	5.0	41,213	17,442*
B	C	0	3,910	0	11.3	21,724	22,886*
J	N	2,095	0	6.0	0	NA	
D	C, F	1,880	1,870	5.4	5.4	30,558	27,780
C	C	0	1,540	0	4.4	30,065	17,003
K	C, F	1,500	0	4.3	0	NA	
L	N, F	0	1,000	0	2.9	NA	
M	C	0	910	0	2.6	66,622	7,661*
N	C	0	910	0	2.6	15,789	17,583
O	C	0	895	0	2.6	3,468	0
P	C, F	0	690	0	2.0	NA	
Q	C	500	670	1.4	1.9	3,927	1,155*
R	C, F	655	0	1.9	0	NA	
S	N	630	0	1.8	0	NA	
T	C, F	580	0	1.7	0	NA	
U	C	0	545	0	1.6	1,925	1,395

* Have approval to hedge anticipatory processing requirements under §1.3(z)(2)(ii)(C).

1/ Type indicators are: C - Commercial; N - Noncommercial; F - Foreign.

2/ Cash positions are as of July 7, 1989; NA - no cash reports required.

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581
(202) 254-6265 FACSIMILE
710-822-0327 TELEX

DIVISION OF
ECONOMIC ANALYSIS

APPENDIX 7

May 16, 1989

VIA FACSIMILE (504) 582-2353

Mr. Colm Cronin
Executive Vice President & C.O.O.
Ferruzzi USA Inc.
1100 Poydras St., Suite 2730
New Orleans, LA 70163

Dear Mr. Cronin:

The purpose of this message is to notify you that we are closely monitoring the liquidation of the May 1989 soybean future on the Chicago Board of Trade. We are concerned by the large open position relative to the small amount of soybeans available for delivery and by the large premium at which the May future has been trading relative to the other soybean futures.

We are further concerned by the large long position that you hold in the May future. We believe that, because of the size of your holdings of about 16.2 million bushels relative to the amount of soybeans available for delivery, your further actions can have a substantial impact on whether or not the price of the May future becomes artificial relative to commercial values. You are prohibited by law from causing an artificial price. Price manipulation is a violation of Sections 6(b), 6(c) and 9(b) of the Commodity Exchange Act.

This message should not be construed as an allegation of price manipulation. Nevertheless, if prices of the May future have been, are now, or should become artificial during liquidation due to your action or inaction, we will consider whether or not to pursue an investigation that could result in charges of price manipulation.

In addition, we are concerned about Ferruzzi's large long position of about 11.6 million bushels in the May 1989 corn future at the Chicago Board of Trade. The open interest in May corn future is large relative to the amount of stocks readily available for delivery and the May future has traded at large premiums relative to other corn futures.

As we discussed today, we ask that you submit Ferruzzi's (including Central Soya) May soybean and corn futures positions to us via telephone at (312) 353-9022 or facsimile (312) 886-8470 by 3:30 p.m. of the same day, May 16 through 19.

Sincerely,

David A. Kass, Director
Market Surveillance Branch
Central Region

cc: Mr. Donald Sternard, Manager Market Surveillance
Office of Investigations and Audits, CBT

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W. WASHINGTON, D.C. 20581
(202) 254-[illegible] FACSIMILE
710-[illegible] TELEX

DIVISION OF
ECONOMIC ANALYSIS

May 18, 1989

VIA FACSIMILE (504) 582-2353

Mr. Colm Cronin
Executive Vice President & C.O.O.
Ferruzzi USA Inc.
1100 Poydras St., Suite 2730
New Orleans, LA 70163

Dear Mr. Cronin:

As I advised you over the telephone this morning, the Commission is concerned with the orderliness of the liquidation of the May 1989 Chicago Board of Trade soybean future and Ferruzzi USA Inc's impact on that liquidation. You have asserted that Ferruzzi's long May position is intended to hedge export sales.

As you are aware, bona fide hedge positions generally are exempt from speculative position limits under Section 4a(3) of the Commodity Exchange Act, 7.U.S.C. §6a(3). Commission Rule 1.3(z)(1), 17 C.F.R. §1.3(z)(1) (1988), defines bona fide hedging transactions and positions and provides in part, that:

> no transactions or positions shall be classified as bona fide hedging for purposes of section 4a of the Act unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices....

The Division of Economic Analysis is concerned that Ferruzzi will not liquidate its current position in the May future in an orderly manner unless Ferruzzi continues to sell the May future in magnitudes at least as large as your net sales of the past two days.

Ferruzzi currently holds more than 90 percent of the long side open interest in the May future. In addition, Ferruzzi owns most of the registered warehouse receipts of soybeans and holds a position in the May future which exceeds apparent deliverable supply not already owned by Ferruzzi. The Division believes that the continued holding of this position, with only one day left to trade, threatens an orderly liquidation of the May future. Accordingly, such positions can not be considered as bona fide hedge positions. Thus, any positions you maintain in excess of 3 million bushels, *i.e.*, the spot month speculative position limit, as of the close of business on May 19 can not be considered to be *bona fide* hedge positions. Unless your position is substantially reduced, we will consider referring this matter to the Division of Enforcement for appropriate legal action.

Moreover, please note Commission Rule 150.5 provides, in part, that:

> Nothing in this part shall be construed to affect any provisions of the Act relating to manipulation or corners....

Therefore, compliance with speculative limit provisions does not relieve you of your responsibility to avoid any action (including the continued holding of a position at or below speculative position limits) which causes the market to be manipulated. The Division believes that your actions will, in large measure, determine whether the May soybean future expires in an orderly fashion.

Sincerely,

John Mielke
Acting Director

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Chicago Board of Trade

June 27, 1989

Mr. Colm Cronin
Executive Vice President & C.O.O.
Ferruzzi USA, Inc.
1100 Poydras St., Suite 2730
New Orleans, LA 70163

Dear Mr. Cronin:

The purpose of this letter is to notify you that the Business Conduct Committee is closely monitoring the expirations of the July '89 soybean, corn, and wheat futures contracts and Ferruzzi's part in those expirations. Also, the Committee is monitoring both Ferruzzi's futures and cash market activity.

The Committee is very concerned about the large position that Ferruzzi holds in the July '89 soybean, corn, and wheat futures. The Committee has interviewed cash market participants and believes that there may be sources of soybeans, corn, and wheat available at prices equal to or more economic than taking delivery at the Chicago Board of Trade. In the past you have been apprised that the Committee has the responsibility of maintaining market integrity through the expiration of each contract. In the event the Committee finds that a member has acted irresponsibly, the Committee has the authority to fine up to $25,000 per violation, suspend such members for up to 90 days per violation, refer a firm to the Board of Directors for fines up to $250,000, indefinite suspension or expulsion, and, upon approval by the Chairman, take emergency action to force liquidation (See Rules 502.00, 509.00 542.00, 560.00, and Regulation 180.02).

The Committee believes that, because of the size of your positions, your further actions can have a substantial impact on whether or not the price of the July futures become artificial relative to cash market values. If evidence presented to the Committee indicates that prices in the July future have been, are now, or should become artificial due to your action or non-action, the Committee will consider what, if any, disciplinary action it should take. Thus, you are strongly urged to insure an orderly liquidation of your position.

Sincerely,

Wallace Q. Wiesenborn

Wallace Q. Wiesenborn
Chairman
Business Conduct Committee

cc: Edward Varin

LaSalle at Jackson
Chicago, Illinois 60604
312 435 3600

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Chicago Board of Trade

July 7, 1989

Mr. Paulo Agostini
Vice President
Ferruzzi Finanziaria S.P.A.
1100 Poydras St., Suite 2730
New Orleans, LA 70163

Privileged and Confidential

Dear Mr. Agostini:

In recent weeks, the Business Conduct Committee ("Committee") has met with representatives of Ferruzzi, U.S.A. and Central Soya on behalf of Ferruzzi Finanziaria S.P.A. ("Ferruzzi") regularly concerning the seriousness with which the Committee regards the large position that your firm holds in the July 1989 soybean futures contract. The Committee informed you of its similar concerns during the expiration of the May 1989 soybean futures contract and those concerns have intensified during the current soybean expiration.

On May 31, 1989, this Committee directed Ferruzzi and the other major position holders of the July 1989 soybean contract to appear before the Committee to justify their positions. At that point, Ferruzzi held approximately 16% of the total open interest in July 1989 soybean futures. The Chicago Board of Trade Market Surveillance staff remained in virtually daily contact with Ferruzzi, requesting the submission of cash contracts underlying its hedge positions. On June 27, 1989, this Committee again notified Ferruzzi of its extreme concern regarding your position. On first notice day for the July contract, June 30, 1989, Ferruzzi held approximately 33% of the open interest.

The Committee directed Ferruzzi to appear on July 5, 1989 to discuss the Committee's concerns about the rate of liquidation by Ferruzzi in the July contract and old crop soybeans generally. On that date, in the July contract, Ferruzzi not only held approximately 44% of the total open interest, but also held 85% of the registered receipts.

As was discussed in detail during that meeting, the Committee has received information which indicates that cash soybeans are available, that economically appropriate means exist for Ferruzzi to lift its alleged hedge in the July contract, and that Ferruzzi has not availed itself of these opportunities.

The July 5 meeting concluded with the Committee directing Ferruzzi to reduce its positions immediately and aggressively by all means including but not limited to aggressively buying in the cash market for soybeans and liquidating its long July position as it

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Chicago Illinois 60604
312 435 3500

Paulo Agostini
July 7, 1989
Page Two

acquired cash soybeans and/or offsetting the long position on the trading floor. Ferruzzi indicated its understanding of the Committee's direction. To the Committee's dismay, Ferruzzi purchased only minor cash soybeans on July 6 and its cash bids were substantially under the market. As you are no doubt aware, Ferruzzi did not substantially liquidate any part of its July position on July 6.

Nine trading days remain before the July contract expires. The Committee expects Ferruzzi to commence substantial daily reductions of its position immediately. The Committee prefers not to impose a specific number or percentage requirement, but in light of the time remaining before expiration and the magnitude of your position, the Committee will consider a substantial reduction to be three million bushels per day.

If Ferruzzi has not reduced its position substantially on Monday, July 10, 1989, the Committee will request that the Board of Directors take emergency action under CBOT Rule 180.00 to ensure the orderly liquidation of this contract. Nothing in this letter should be construed as a limitation on the Committee's authority to take disciplinary action against Ferruzzi. The Committee considers this your last chance to demonstrate the firm's good faith and to begin to honor its obligations as a member of the Exchange.

Sincerely,

Wallace G. Weisenborn
Chairman
Business Conduct Committee

cc: Colm Cronin
James L. Fox, Esq.
David Swanson
Lawrence Hunt, Esq.

Ferruzzi U.S.A., Inc.
Suite 2730 Energy Centre
1100 Poydras Street
New Orleans, Louisiana 70163
Phone: (504) 583-2200
Telex 682;288 (MCI)
Telefax (504) 583-2346

Ferruzzi U.S.A.

July 10, 1989

FEDERAL EXPRESS

Wallace G. Weisenborn
Chairman
Business Conduct Committee
Chicago Board of Trade
141 West Jackson Street
Chicago, Il. 60604

Dear Mr. Weisenborn:

Ferruzzi received your letter dated July 7th concerning the expiration of the July 1989 Soybean futures contract. This letter is in response to it.

In recent months Ferruzzi has demonstrated its continued willingness to co-operate with the B.C.C. ("Committee") during its monitoring of the expiration of both the May and July Soybean contracts. Ferruzzi has provided in good faith all information and documents requested to both the Committee and the C.F.T.C. Moreover it was stated by the Committee and understood by Ferruzzi and Counsel at the July 5th meeting that Ferruzzi up to that point and time had acted in the market place in an economic manner.

Ferruzzi and Counsel understood from the July 5th meeting that from then through to the expiration of the July Soybean contract Ferruzzi would aggressively attempt to originate cash soybeans below and up to delivery values while simultaneously liquidating its legitimate hedge position in July futures. To Ferruzzi's surprise the Committee expressed dismay at Ferruzzi's market action on July 6th.

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Page 2
July 10, 1989

. . . .

Since it is Ferruzzi's understanding that there is a continuous dialogue between the Committee and C.F.T.C. we assumed you were aware that representatives of Ferruzzi were meeting with the C.F.T.C. in Chicago on July 6th and were unable to discuss the results of both the Committee's and C.F.T.C.'s meetings with other Ferruzzi Group Managers throughout the world until their return on July 7th.

On July 7th Ferruzzi raised its cash bids by 8 cents per bushel for soybeans, and against purchases liquidated July Soybean futures. We did not wish to move all in one day to full delivery values since this could be construed by the market as being overly aggressive, therefore perhaps, artificial and manipulative.

Ferruzzi's conclusion and intention coming from the July 5th meeting, is, that in the event that cash soybean values go to delivery levels, that is cash values are equal to futures values, and this does not produce cash in quantities sufficient to liquidate all of the July hedges, then Ferruzzi will maintain the balance of its hedges in the July. Should this occur Ferruzzi fully expects the Committee to allow the July soybean Contract and the market to work freely as part of the normal and accepted price discovery process.

If under these circumstances because of Committee action Ferruzzi is prevented from holding its hedge in the July soybean futures, while being economical to do so, it will be forced to use any means at its disposal to recover all damages incurred due to such action.

As usual we will be available if any further information is required.

FERRUZZI U.S.A, INC.
a wholly controlled subsidiary of Ferruzzi Finanziaria S.p.A.

Colm C. Cronin
Executive Vice-President

Edward Varin
Executive Vice-President

. . . .

cc: Yvonne Downs
David Seagren
Karsten Malhman
Dwayne Schaumbach
David Kass
James Fox, Esq.
Lawrence Hunt, Esq.
Jeffrey Smith
David Swanson
Francesco Camoletto
Frank Gleason
Roland Gagliardini

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

July 11, 1989

Mr. C. Lockwood Marine
Senior Vice President - Commodities
Central Soya
Fort Wayne, Indiana 46802

Dear Mr. Marine:

This acknowledges your letter of June 30, 1989, providing data on your anticipated processing requirements for soybeans. The data furnished, including annual anticipated processing requirements for calendar year 1990 of [redacted] bushels of soybeans, meet the requirements of Section 1.48 of the regulations under the Commodity Exchange Act.

Your long futures position in soybeans may be classified as hedging under Section 1.3 (z)(2)(ii)(C) of the regulations only to the extent that it represents unfilled anticipated requirements for processing. These requirements are calculated by deducting from your annual requirements, your inventories and fixed-price purchases of soybeans and the smaller of your inventories of oil or meal. Also deducted is your long futures position in soybeans purchased against the larger of your oil or meal fixed-price sales. Assuming that your remaining inventory and fixed-price purchase items will be constantly changing, the amount that you are eligible to hedge as unfilled anticipated processing requirements also will change by the same amounts. At no time should your long hedging position for unfilled requirements exceed the actual amount of your unfilled anticipated requirements.

Commission Rule 1.3 (z)(1), 17 C.F.R. § 1.3 (z)(1) 1988, which defines bona fide hedging transactions and positions, further provides in part that

> no transactions or positions shall be classified as bona fide hedging for purposes of section 4a of the Act unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices.... (emphasis added)

The Commission is concerned that due to short supplies of old crop soybeans, the substantial ownership of soybeans in deliverable locations by the Ferruzzi group, of which Central

Soya is part, and because of the large portion of the open interest in old crop soybean futures currently held by the Ferruzzi group accounts, there is a threat to an orderly liquidation of the July and August 1989 soybean futures on the Chicago Board of Trade. Accordingly, in accordance with the provisions of Rule 1.48 (a), you are hereby notified that the Commission will not consider as bona fide hedging any positions held against anticipated processing requirements by Central Soya or other Ferruzzi group entities during the last three trading days in the July and August 1989 soybean futures contracts.

Additional filings under Rule 1.48 only become necessary when they are specifically requested or when the most recent filing of your total requirements, after adjustments for current inventories and fixed-price purchases, falls short of the amount of futures needed to hedge your unfilled anticipated requirements. You should be aware that such additional filings must be submitted at least ten days in advance of the date on which you expect to exceed the amount for which you have been approved.

For the Commission

Jean A. Webb
Secretary of the Commission

cc: Colm Cronin
Ferruzzi USA Inc.

APPENDIX 8

CHRONOLOGY OF EVENTS CONCERNING THE JULY CBT SOYBEAN LIQUIDATION 1/

DATE	EVENTS
05/16/89	Commission staff sent Ferruzzi a warning letter expressing concern about their large long position in the May soybean future.
05/16/89	Chairman Gramm had a conversation with CBT Chairman Mahlmann regarding concerns for an orderly liquidation of the May future.
05/18/89	As directed by Chairman Gramm, the Commission's Director of Market Surveillance telephoned a Ferruzzi official and advised him that any positions maintained in excess of 3 million bushels on the last trading day of the May future would not be considered as bona fide hedges by the Commission. A confirmation letter was FAXed to Ferruzzi that same day.
05/25/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
05/25/89	CBT Board of Directors took emergency action to adopt speculative position limits in grain futures, at levels equalling the Commission's.
05/30/89	CBT and CBT Clearing Corp. increased margins.
05/30/89 & 06/01/89	Commission staff contacted representatives of five soybean processors to gather cash and futures market data, particularly concerning near-term processing requirements.
05/31/89	Chairman Mahlmann advised Commissioners and the Director of Market Surveillance of concerns regarding July soybeans and that large traders would be called before the BCC within a few days.

1/ This chronology does not include every conversation Commission staff may have had with CBT representatives, futures traders, and cash market sources, nor does this chronology include the similar activities being conducted by the CBT staff.

06/01/89	Staff had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/02/89	CBT increased margins.
06/05/89	Representatives of Ferruzzi and four other large market participants appeared before the CBT's Business Conduct Committee (BCC) to discuss their positions and intentions.
06/06/89	Commission staff met with Ferruzzi representatives in Chicago to gather cash and futures market data, including requests for full documentation of their export and processing requirements. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/07/89 & 06/08/89	Commission staff contacted representatives of the five firms that operate the elevators approved for soybean deliveries and Ferruzzi about the present ownership of soybean stocks in deliverable position.
06/08/89	Ferruzzi representative contacted Commission staff concerning delays encountered while loading out soybeans from Chicago elevators.
06/08/89	Commission staff contacted an elevator operator representative about loadouts from Chicago elevators.
06/09/89	Commission staff had a further conversation with a Ferruzzi representative about soybean loading delays from Chicago elevators.
06/09/89	Had conversation with a large grain merchant to gather cash and futures market data.
06/12/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/13/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/14/89	Had conversation with Ferruzzi's representative

	to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/15/89	Senior Commission staff met in Chicago with senior CBT staff to discuss concerns about the orderly liquidation of the July future.
06/19/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/19/89	CBT increased margins.
06/21/89	Commission staff contacted a large grain merchant to gather cash and futures market data.
06/21/89	Had conversation with a trader who expressed concern about July soybean liquidation.
06/22/89	Commission staff contacted a cash grain broker to gather cash and futures market data.
06/22/89	Commission staff contacted a grain exporter and processor to gather cash and futures market data.
06/22/89	Commission staff contacted Ferruzzi's representative to gather cash and futures market data.
06/27/89	Ferruzzi's representative contacted Commission staff expressing a willingness to meet with the BCC, the CBT Chairman, and Commission staff.
06/27/89	Commission staff had conversation with CBT staff to discuss liquidation concerns.
06/27/89	Had conversation with a large grain merchant who expressed concern about July soybean liquidation.
06/27/89	BCC FAXed a warning letter to Ferruzzi expressing the Committee's concern about the firm's large July futures position.
06/28/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff urged Ferruzzi to buy cash and liquidate July futures.
06/29/89	Had conversation with a large grain merchant

	who expressed concern about July soybean liquidation.
06/29/89	Had conversation with a large grain merchant who expressed concern about July soybean liquidation.
06/29/89	Commission staff contacted a grain exporter and processor to gather cash and futures market data; the representative expressed concern about July soybean liquidation.
06/29/89	Commission staff contacted a cash grain broker to gather cash and futures market data.
07/05/89	Ferruzzi representatives appeared before the BBC.
07/06/89	CBT/CBT Clearing Corp. increased margins
07/06/89	Commission staff met with Ferruzzi's representatives in Chicago to gather cash and futures market data. Commission staff advised Ferruzzi that Central Soya's long hedges against processing requirements were being reviewed and, within a few days, Ferruzzi would be notified to what extent, if any, they would be permitted to hold those hedges in the spot month. Commission staff urged Ferruzzi to increase cash bids, aggressively buy cash beans, and liquidate July futures.
07/06/89	Commission staff contacted CBT staff to discuss liquidation concerns.
07/06/89	Director of Market Surveillance contacted CBT Vice President to discuss surveillance concerns and get his evaluation based on Ferruzzi's appearance before the BCC. Chairman Gramm also discussed the situation with Chairman Mahlmanm.
07/07/89	The BCC sent a letter to Ferruzzi asking the firm to liquidate 3 million bushels of July futures per day as a "last chance" before recommending emergency action.
07/10/89	Ferruzzi sent a letter to the BCC in response to the ultimatum letter received on July 7.
07/10/89	Had conversation with Ferruzzi's representative to gather cash and futures market data. Commission staff strongly urged Ferruzzi to increase cash bids further, aggressively buy cash

beans, and liquidate July futures.

07/10/89	Commission staff contacted CBT staff to evaluate the extent to which they had been contacting Ferruzzi representatives and brokers for market information, intentions to liquidate, and positions.
07/10/89	CBT Vice President informed Director of Market Surveillance that the BCC was recommending that the CBT Board of Directors consider emergency action. CFTC advised CBT that the Commission was about to revoke Ferruzzi's hedge exemption for anticipatory processing requirements during the last three trading days in July and August soybean futures.
07/10/89	CBT Chairman Mahlmann called Chairman Gramm and CBT Vice President called Director of Market Surveillance to discuss the July liquidation and to notify her that the BCC had recommended to him that the Board consider taking emergency action.
07/10/89	Chairman Gramm met with surveillance staff and asked for list of alternative emergency actions that might be appropriate in the circumstances.
07/11/89	Chairman Gramm met with staff in the morning before calling Chairman Mahlmann.
07/11/89	Chairman Gramm called Chairman Mahlmann to discuss potential actions to resolve the situation in the July future.
07/11/89	The Surveillance Director called CBT Vice President and discussed various alternatives for regulatory actions to address the July situation, confirmed that the Commission had revoked some of Ferruzzi's hedging privileges, and FAXed a copy of the letter to Ferruzzi.
07/11/89	CBT/CBT Clearing Corp. decreased margins to pre-July 6 levels (associated with a return to normal daily price limits).
07/11/89	The Commission FAXed a letter to Central Soya revoking their hedge exemption for anticipatory processing requirements during the last three trading days in July and August Soybean futures.

07/11/89	Commission staff contacted three grain exporters to gather cash and futures market data.
07/11/89	CBT Board of Directors issued an emergency order relative to the July future and advised CFTC of that action.
07/12/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/13/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/13/89	Ferruzzi failed to get a temporary restraining order in the U.S. District Court in Chicago.
07/14/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/14/89	Commission staff contacted a grain merchant representative to gather cash and futures market data.
07/17/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/18/89	CBT/CBT Clearing Corp. increased margins
07/18/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/19/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/19/89	Commission staff contacted a large merchant's representative to gather cash and futures market data.
07/20/89	Commission staff discussed with CBT staff the extent of compliance with the emergency order.
07/20/89	Commission staff contacted Ferruzzi's representative to gather cash and futures market data.
07/20/89	The July soybean future expired at noon C.D.T.

APPENDIX 9

EMERGENCY ALTERNATIVES

STANDARDS:

-- forceful enough to deal with problem at hand

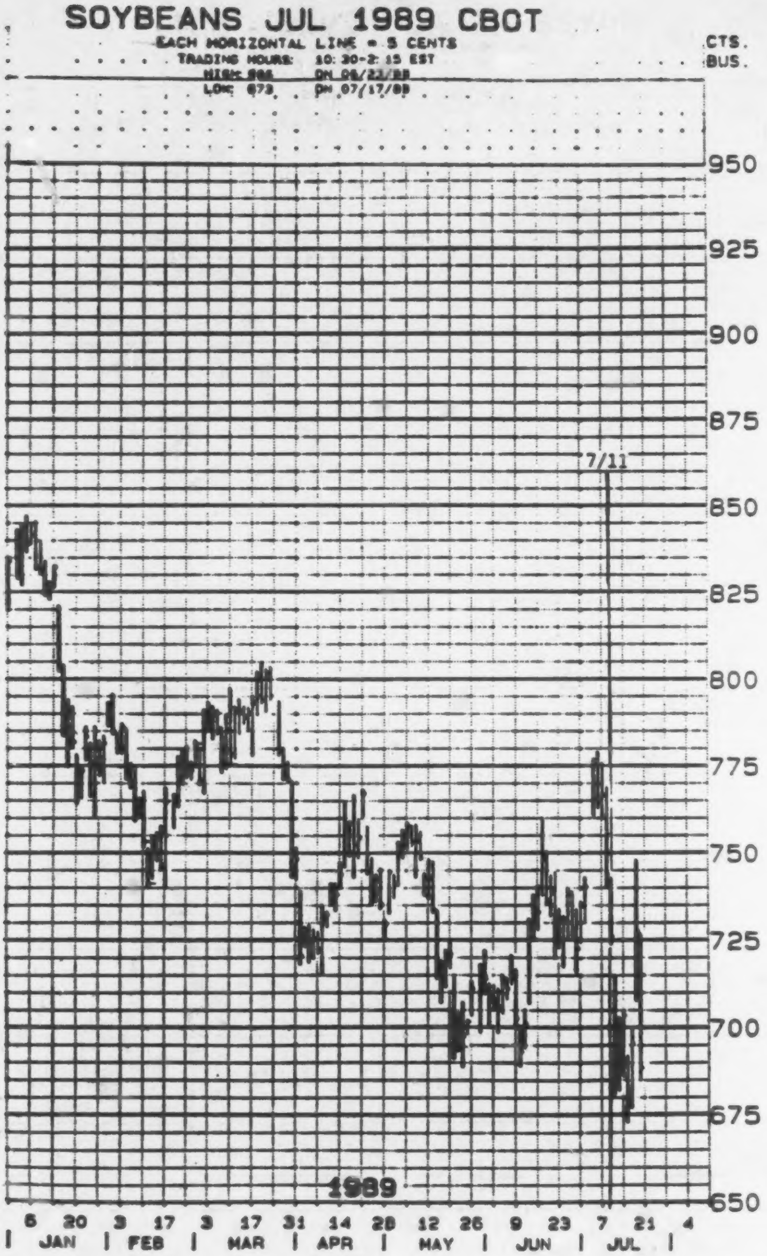
-- as broad as possible, but still focussed on the problem area;

-- not too forceful as to cause a bigger disruption than taking no action at all.

ALTERNATIVES:

1. Revoke hedge exemptions of all traders in July beans and require reduction to speculative limit of 3 million bushels by x date. (affects 1 long & 1 short)
2. Require a daily proportionate decrease of all positions, excepting new sales for delivery evidenced by grain in-hand. For example, all accounts must reduce by (90% ÷ 7 =) 13% per day for the last 7 trading days.
3. Cease trading and close out all contracts at a price (the last prevailing settlement price?)
4. Revoke F's hedge exemption and specify a mandatory liquidation schedule or provide a date by which F must come into compliance.
5. Provide a cash settlement alternative to shorts who cannot deliver beans by last delivery date (full contract value based on LTD settlement price + x % penalty). Announce the provision and penalty factor before LTD.

APPENDIX 10A



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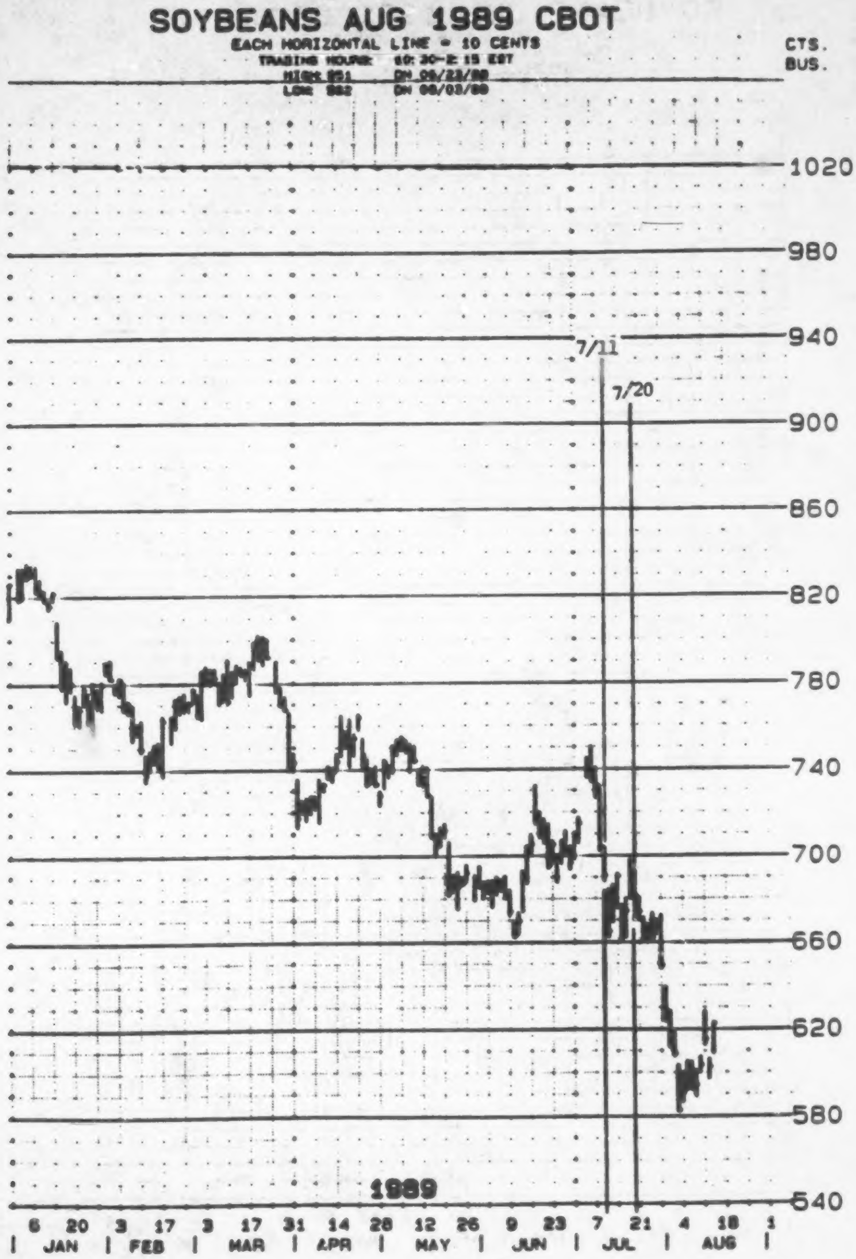
APPENDIX 10B



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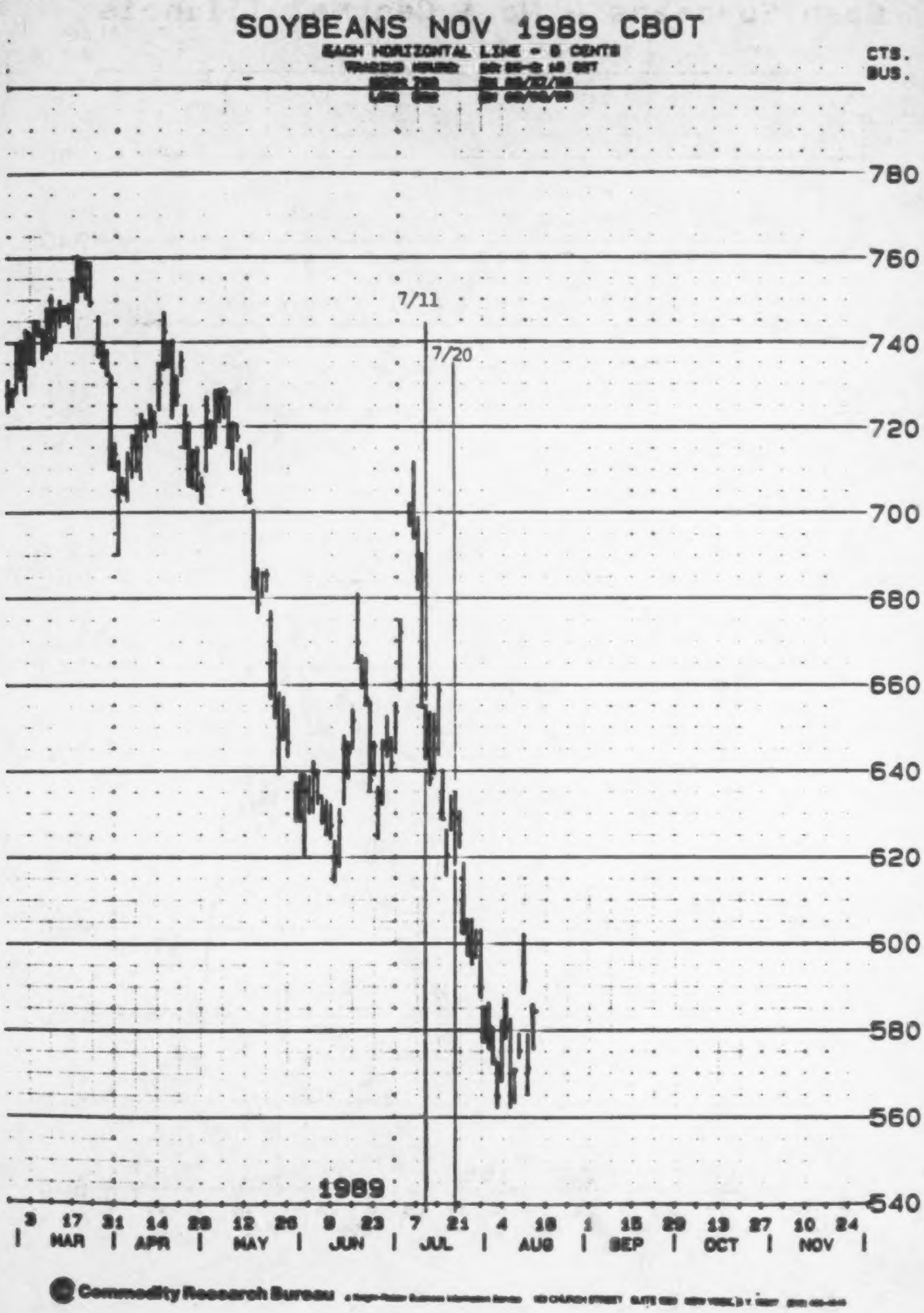
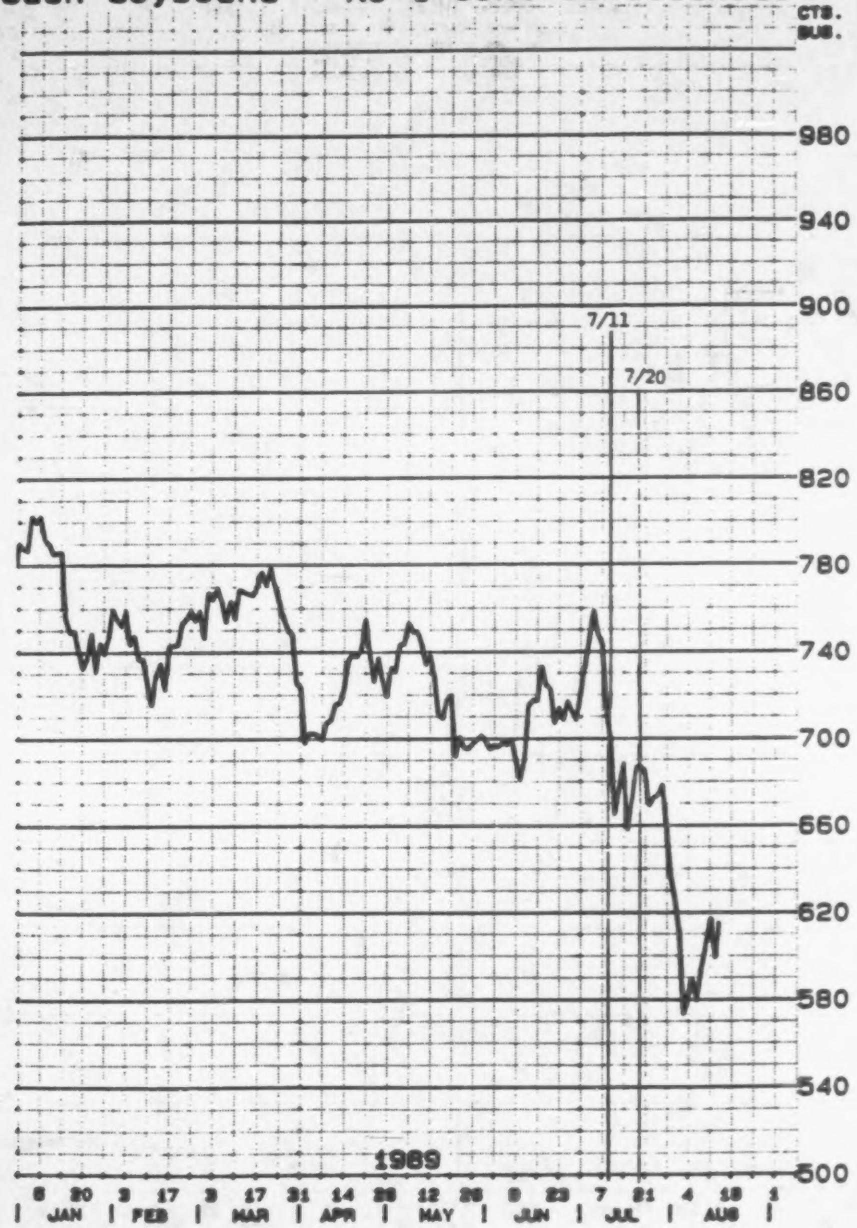
APPENDIX 10C



APPENDIX 10D

Cash Soybeans - No 1 Central Illinois



Commodity Research Bureau

APPENDIX 11

SOYBEAN CASH PRICE CHANGES DURING JULY 1989
(CENTS PER BUSHEL)

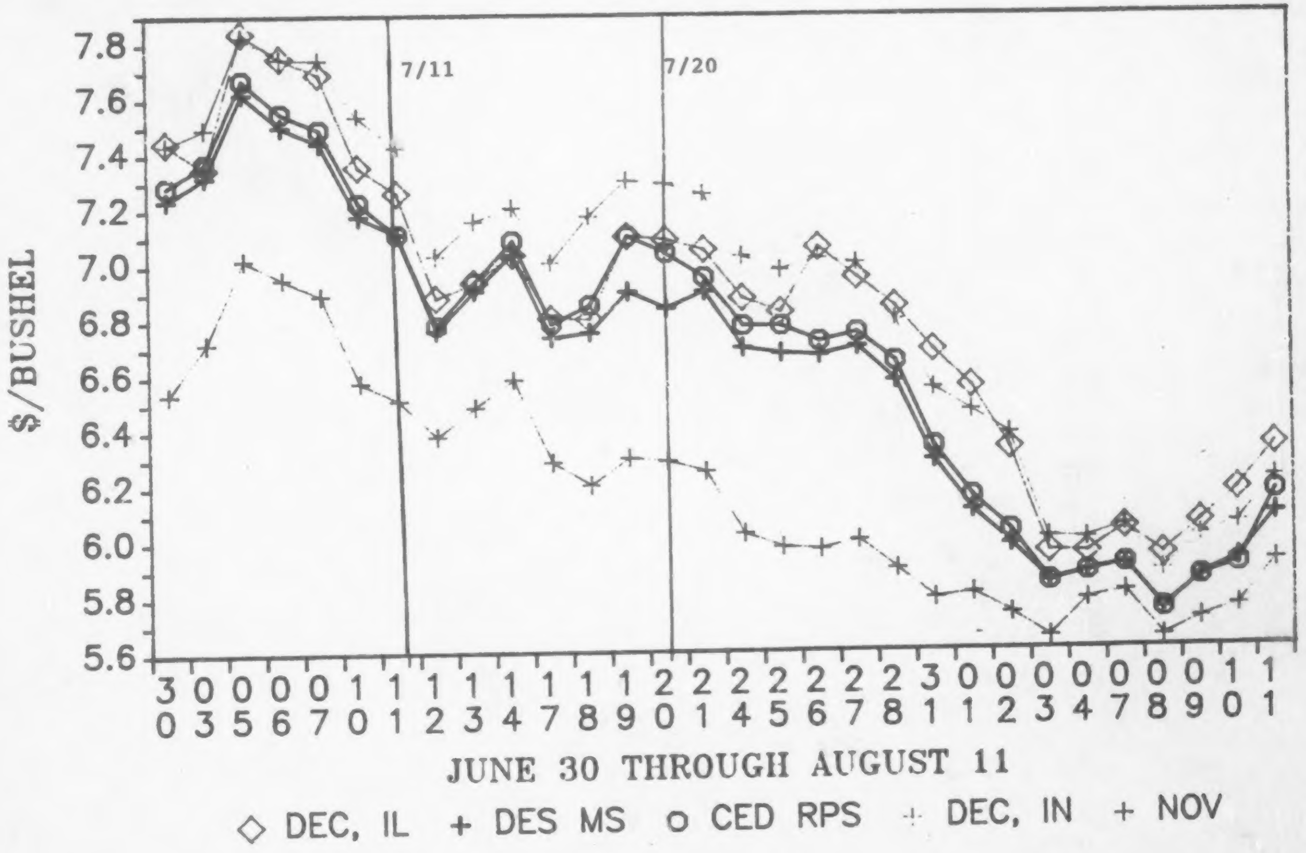
MARKET	JULY 5-11	JULY 12	JULY 12-20	JULY 20-AUG 2
Decatur, Ill.	-58	-38	+20 3/4	-75 3/4
Des Moines, Ia.	-51	-35	+ 7 3/4	-85 3/4
Decatur, Ind.	-40	-39 1/2	+25 3/4	-90 3/4
Gulf Barge	-63	-31	+25 3/4	-87 1/4
Upper Ill. River	-53	-32	+25 1/4	-79

CASH PRICES	JULY 5-11	JULY 11-20	JULY 20-AUG 2
Central Ill. Soybeans	- 8.0%	- 1.6%	-11.2%
Central Ill. Corn	- 9.1%	- 3.6%	- 6.9%

APPENDIX 12

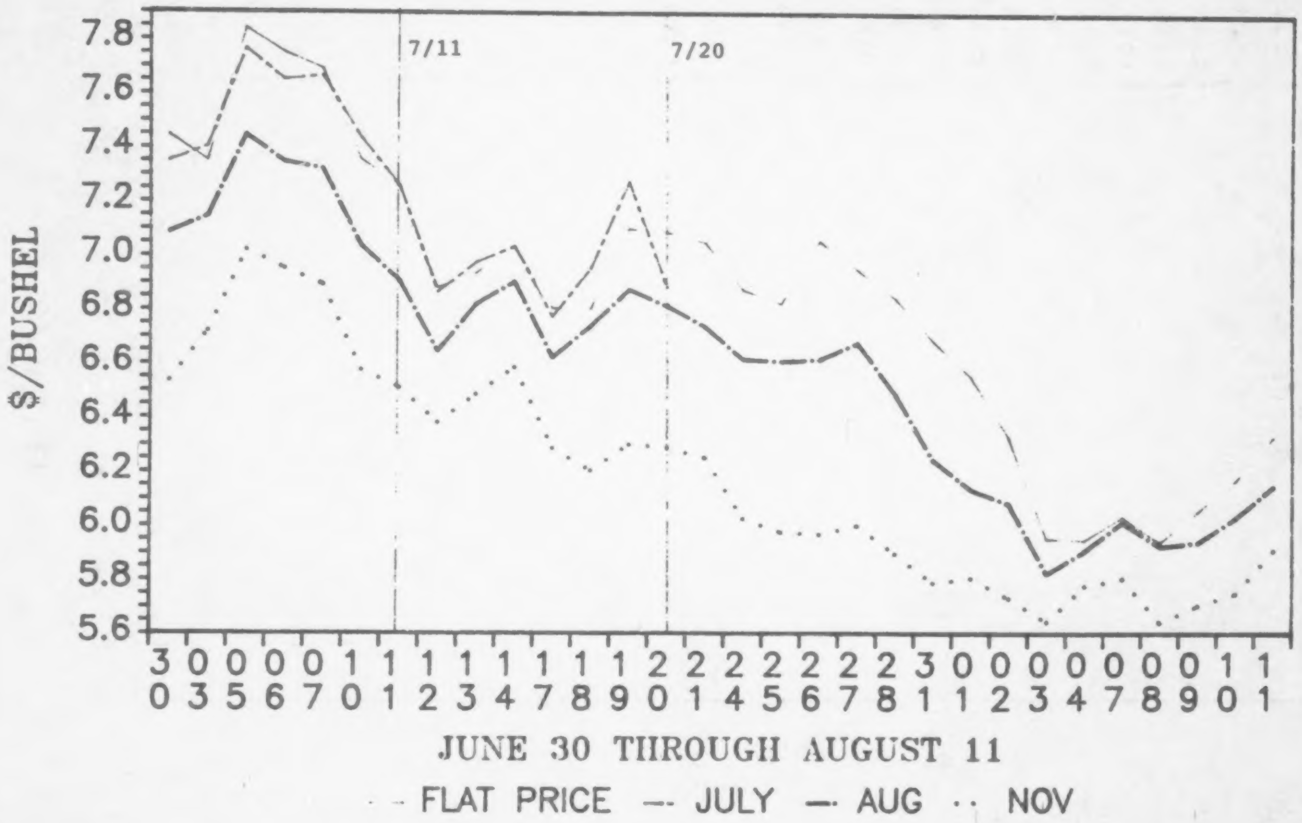
SELECTED SOYBEAN CASH PRICE DATA

ON A FLAT PRICE BASIS

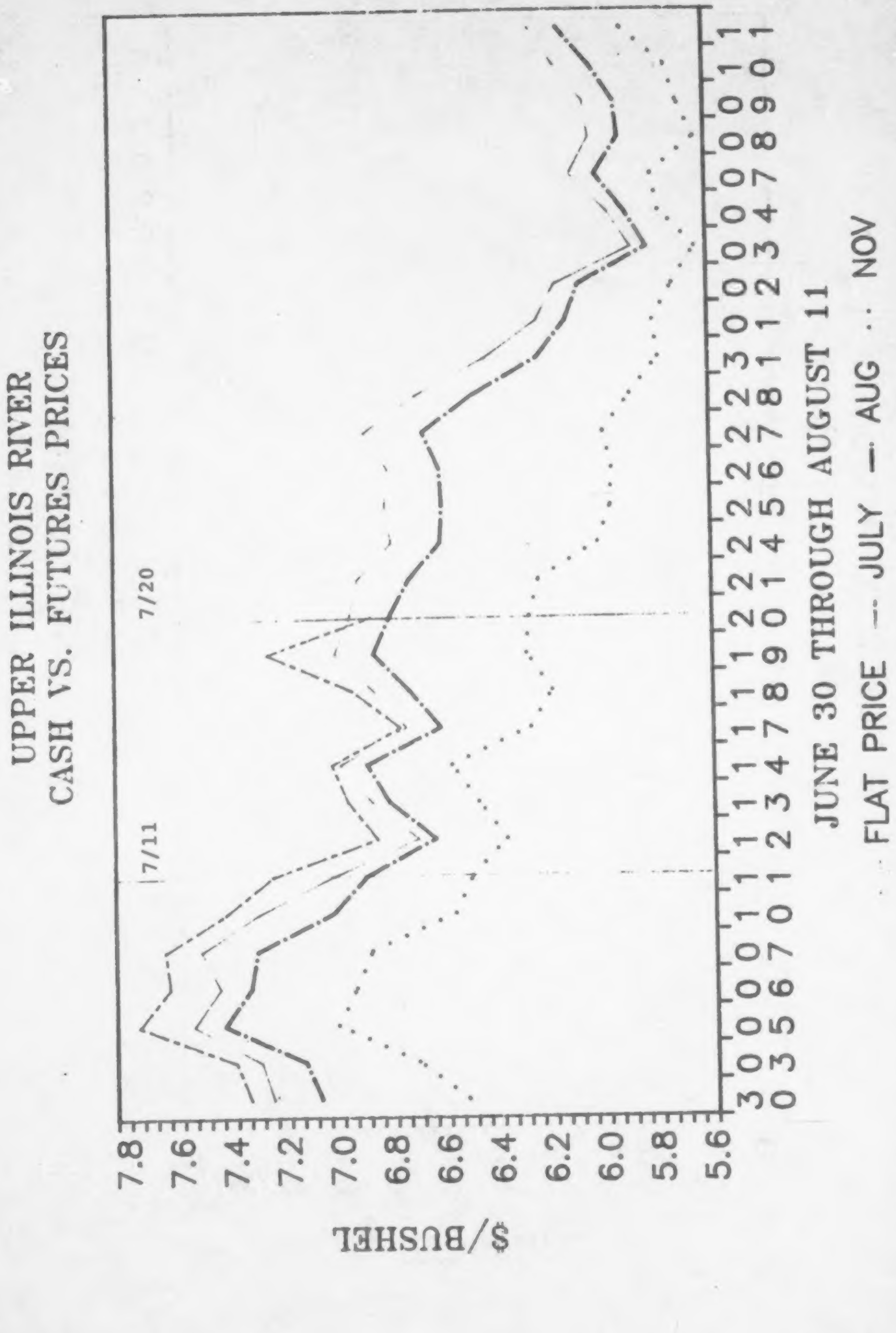


APPENDIX 13A

DECATUR, ILLINOIS
CASH VS. FUTURES PRICES

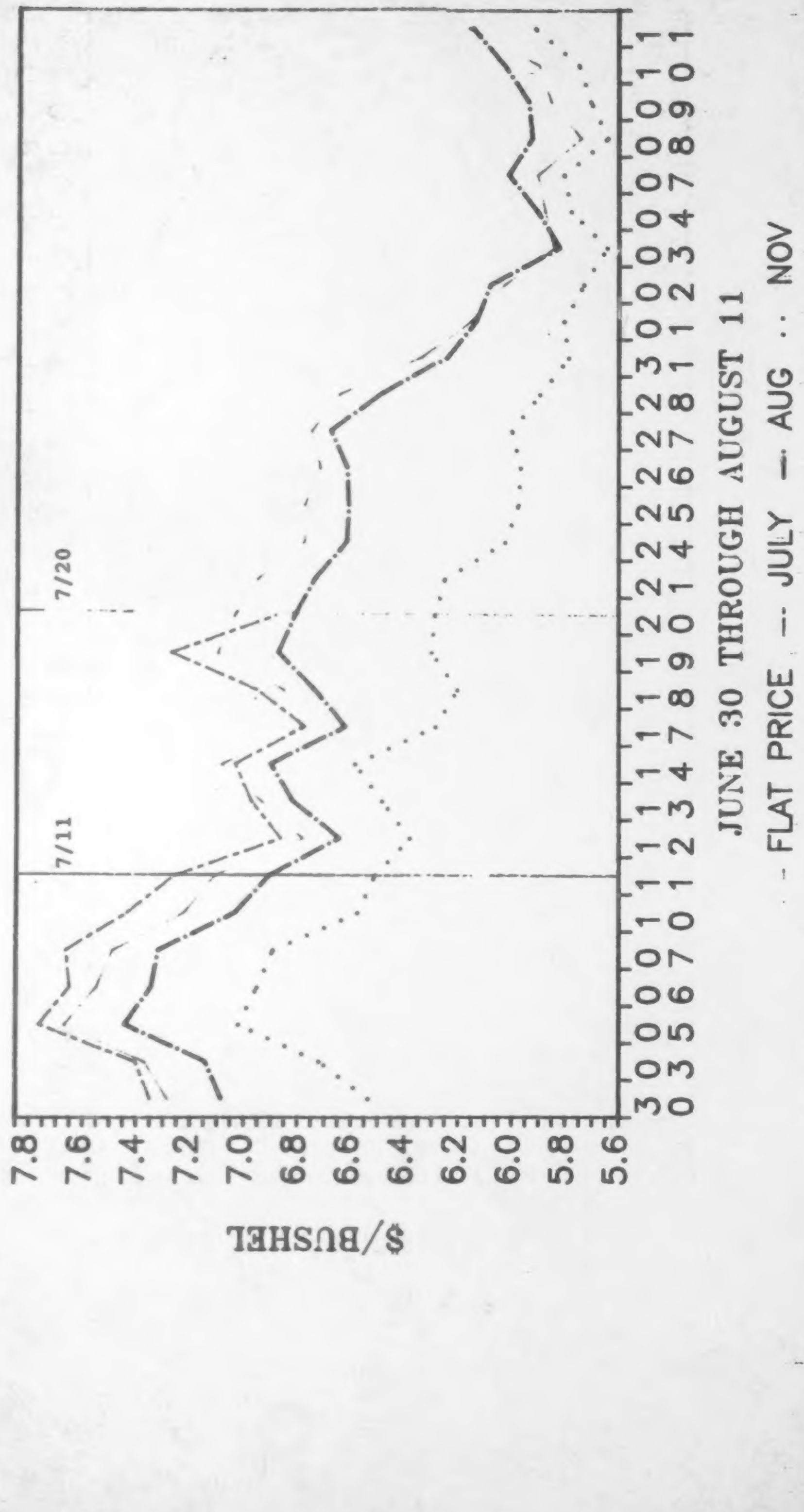


APPENDIX 13B

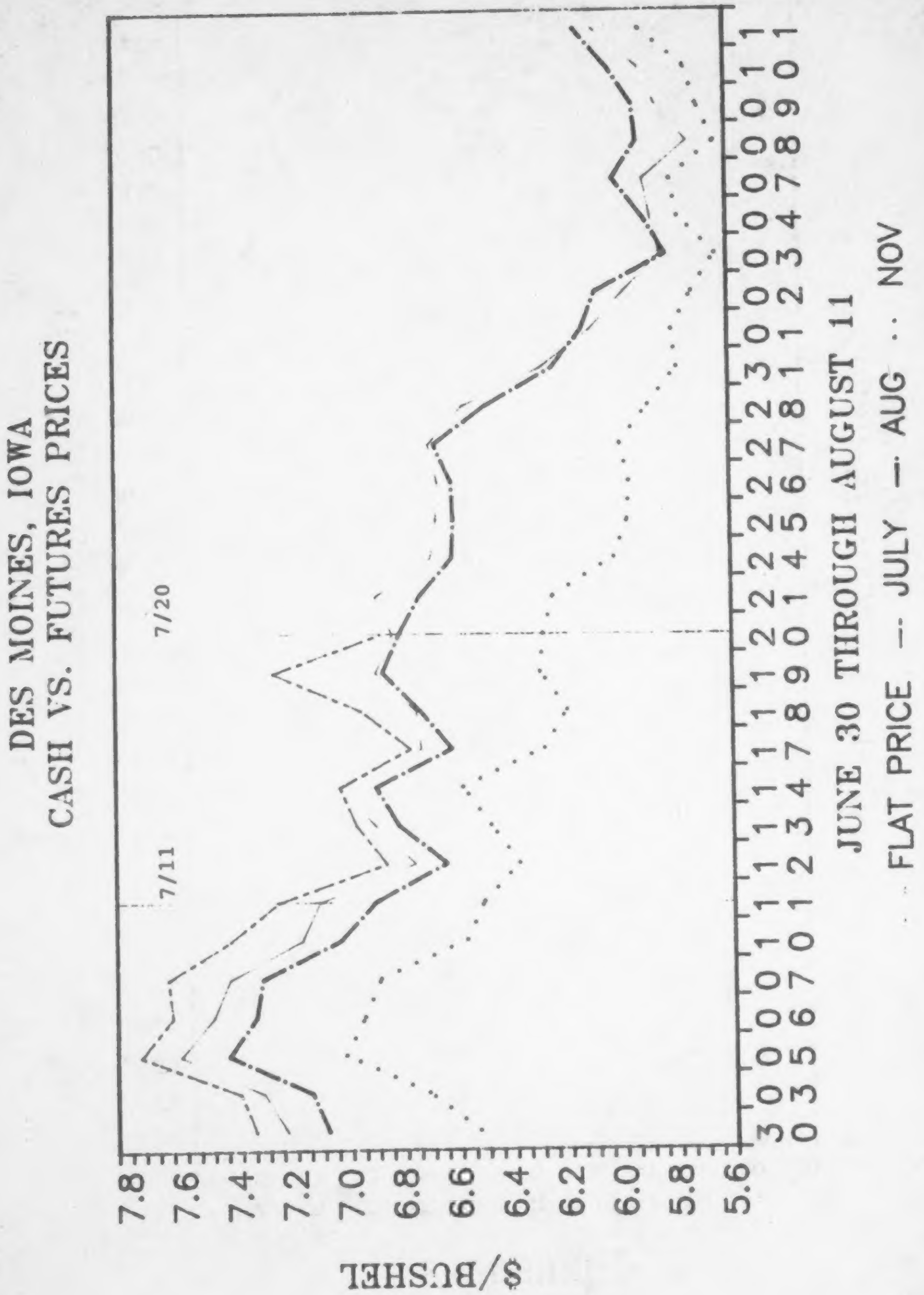


APPENDIX 13C

CEDAR RAPIDS, IOWA
CASH VS. FUTURES PRICES

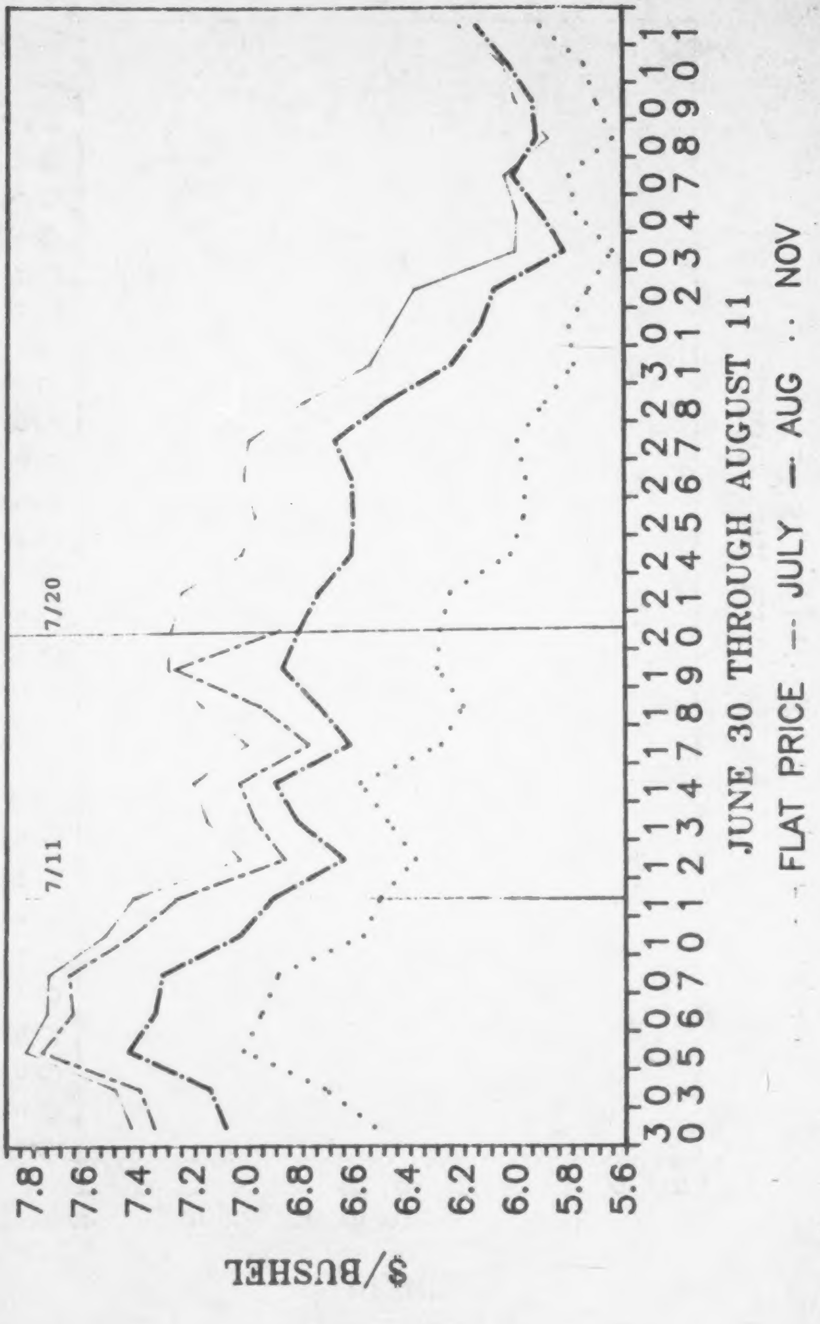


APPENDIX 13D

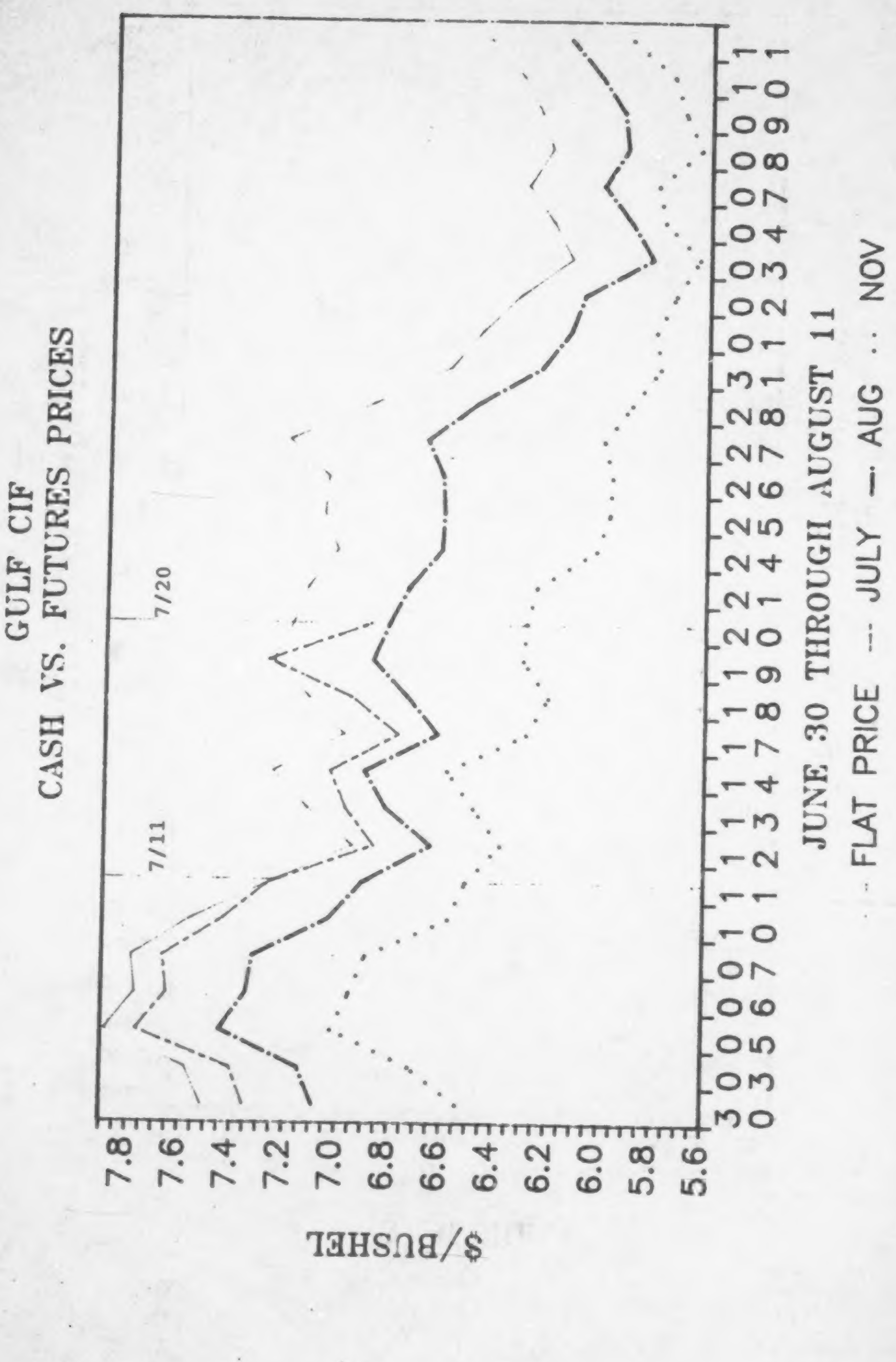


APPENDIX 13E

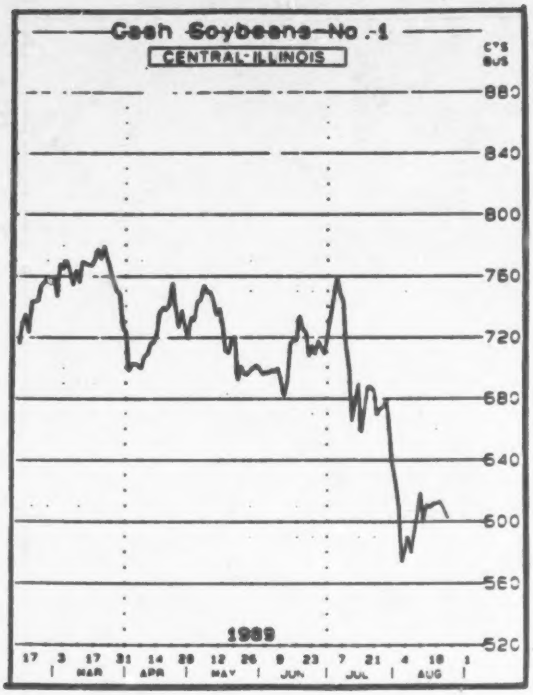
DECATUR, INDIANA
CASH VS. FUTURES PRICES

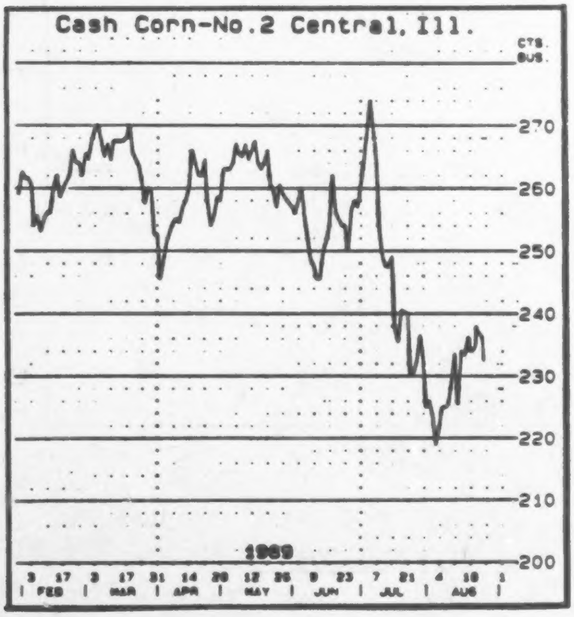


APPENDIX 13F



APPENDIX 14





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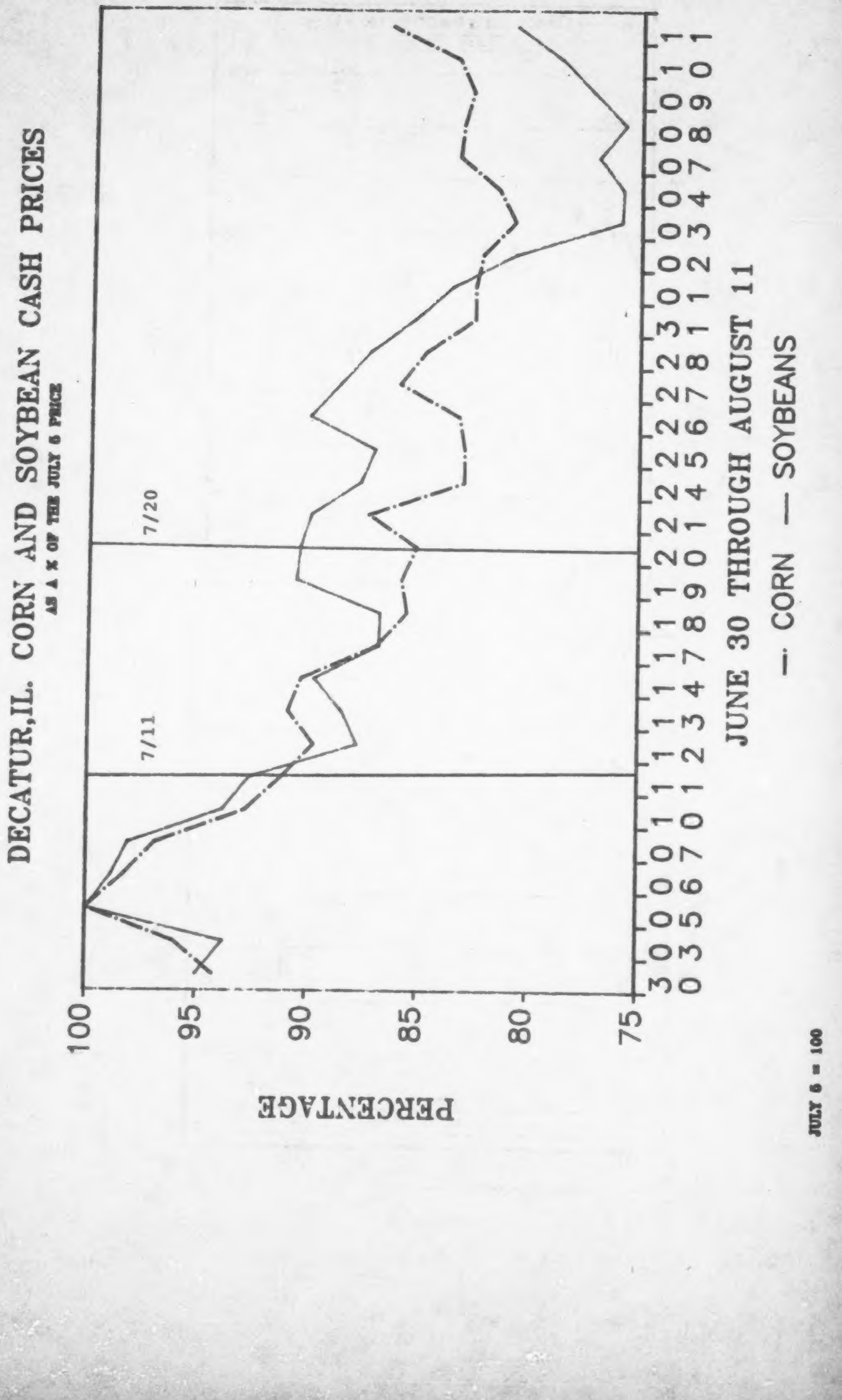
APPENDIX 15A



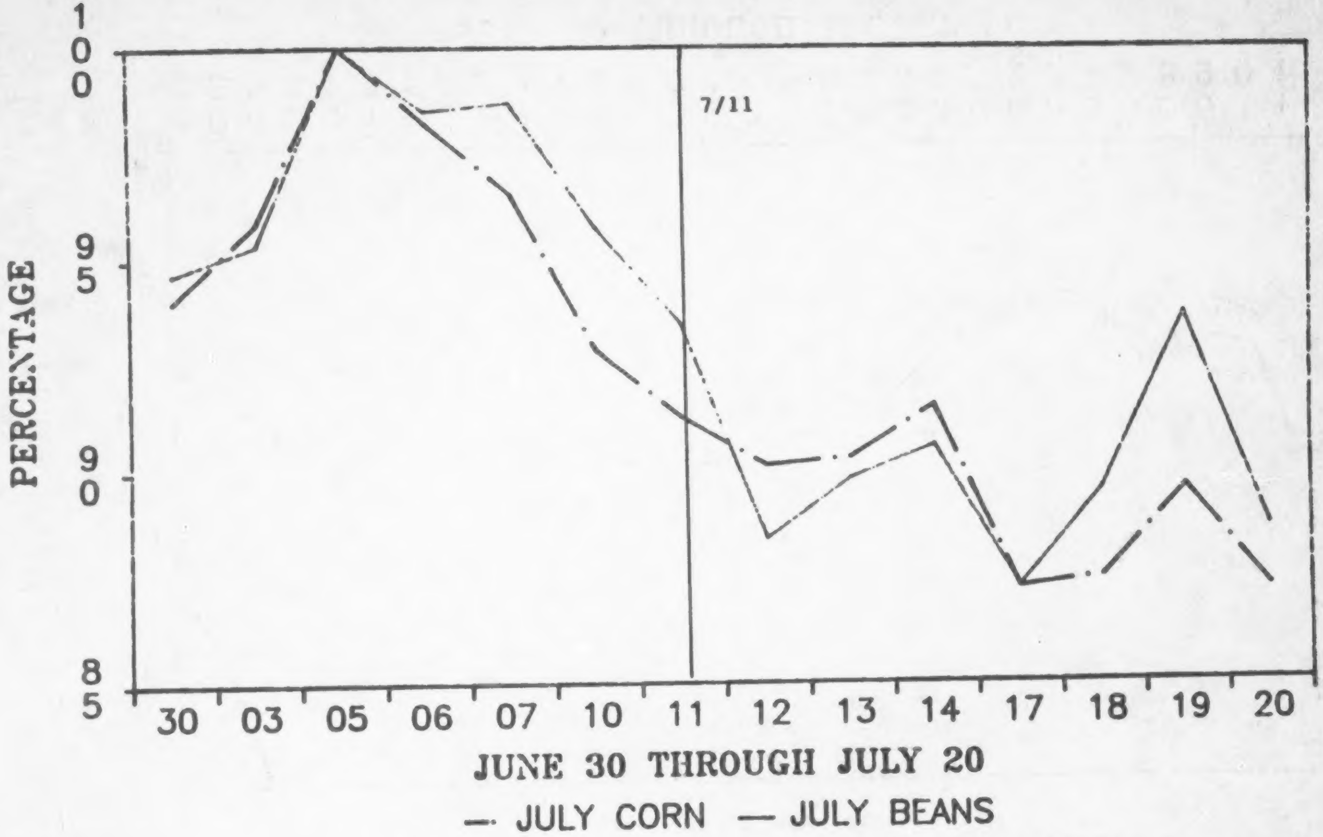
DECATUR,IL. CORN AND SOYBEAN CASH PRICES

AS A % OF THE JULY 5 PRICE

APPENDIX 15B

CBT CORN AND SOYBEAN FUTURES PRICES

AS A % OF THE JULY 5 PRICE

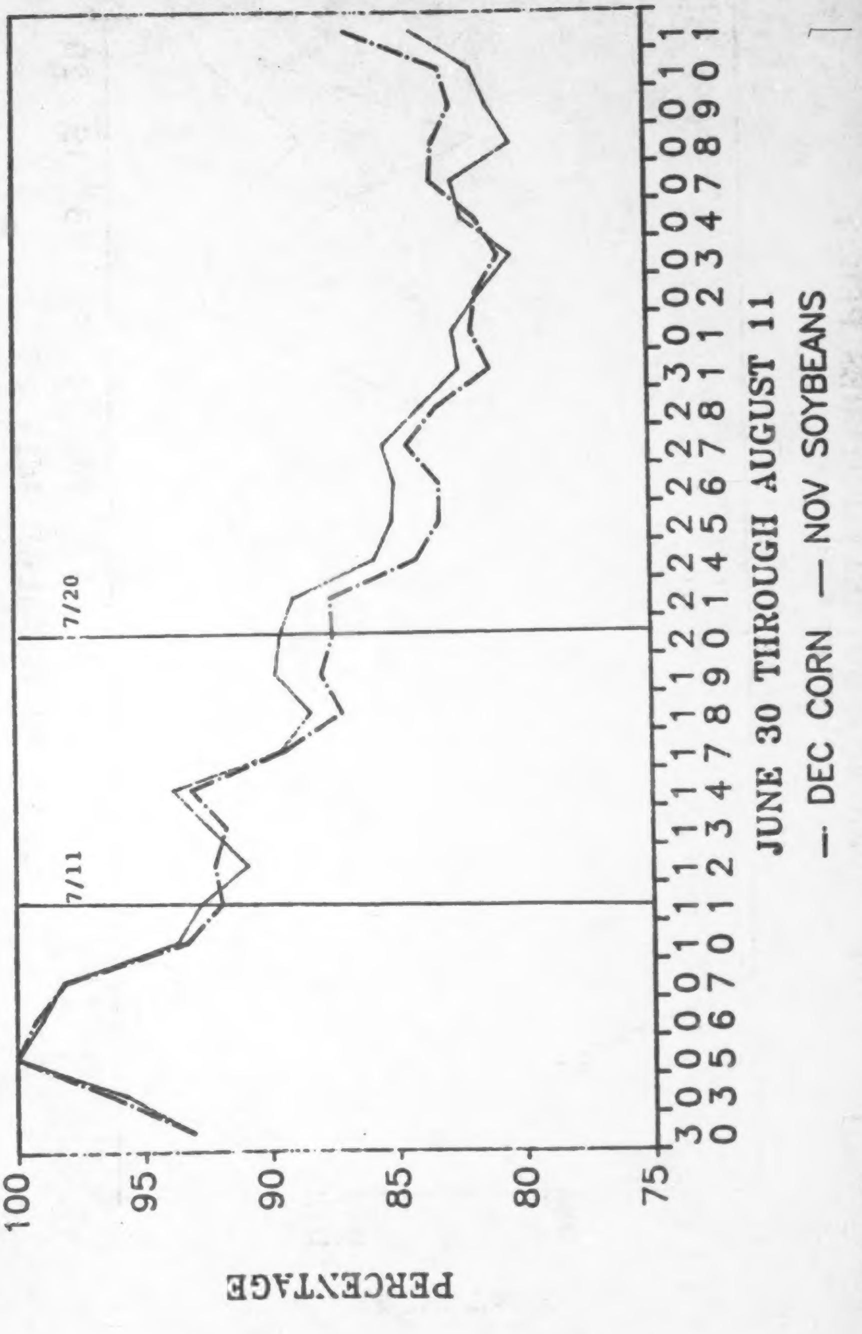


JULY 5 = 100

APPENDIX 15C

CBT CORN AND SOYBEAN FUTURES PRICES

AS A % OF THE JULY 5 PRICE



JUNE 30 THROUGH AUGUST 11

— DEC CORN — NOV SOYBEANS

JULY 5 = 100

SUPPLEMENT TO COMMISSION'S TESTIMONY ON SOYBEANS

COMMODITY FUTURES TRADING COMMISSION
SEPTEMBER 8, 1989

TEN LARGEST TRADERS IN THE JULY 1989 SOYBEAN FUTURE ON JUNE 29, 1989 AND THEIR POSITIONS ON JULY 11, 1989 (IN THOUSAND BUSHELS)

		6/29/89				7/11/89			
		POSITION 2/		% OF OPEN INTEREST		POSITION		% OF OPEN INTEREST	
TRADER	TYPE 1/	LONG	SHORT	LONG	SHORT	LONG	SHORT	LONG	SHORT
A	C, F	23,240	1,435	36.1	2.2	20,475	1,735	59.0	5.0
B	C	0	9,585	0	14.9	0	3,910	0	11.3
C	C	0	3,645	0	5.7	0	1,540	0	4.4
D	C, F	3,215	2,530	5.0	3.9	1,880	1,870	5.4	5.4
E	N, F	2,750	0	4.3	0	NR	NR	-	-
F	N	2,425	0	3.8	0	175	0	0.5	0
G	C	0	2,410	0	3.7	0	260	0	0.7
H	C, F	0	2,305	0	3.6	NR	NR	-	-
I	C, F	0	1,700	0	2.6	0	380	0	1.1
J	N	1,620	0	2.5	0	2,095	0	6.0	0

	6/29/89	7/11/89
OPEN INTEREST	64,300,000 bu.	34,715,000 bu.
DELIVERABLE SUPPLY	13,100,000 bu.	13,000,000 bu.

1/ Type indicators are: C = Commercial; N = Noncommercial; F = Foreign.

2/ NR indicates that the trader does not hold a reportable position.

ALL TRADERS HOLDING JULY 1989 SOYBEAN FUTURES POSITIONS ABOVE THE CFTC REPORTING LEVEL (500,000 bu.) ON JULY 11, 1989--RANKED BY LARGEST GROSS LONG OR SHORT
(POSITIONS IN THOUSAND BUSHELS)

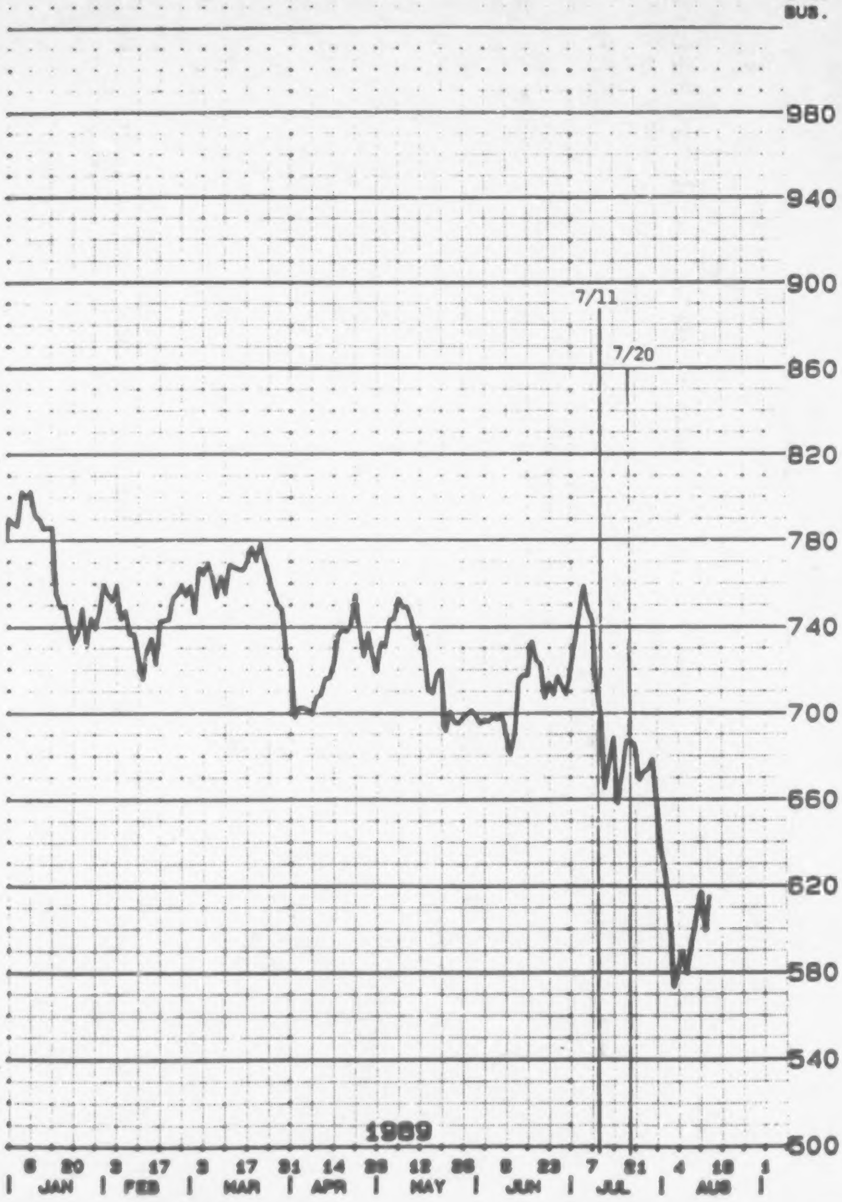
TRADER	TYPE 1/	JULY FUTURES		% OF OPEN INTEREST		CASH POSITION 2/	
		LONG	SHORT	LONG	SHORT	LONG	SHORT
A	C, F	20,475	1,735	59.0	5.0	41,213	17,442*
B	C	0	3,910	0	11.3	21,724	22,886*
J	N	2,095	0	6.0	0	NA	
D	C, F	1,880	1,870	5.4	5.4	30,558	27,780
C	C	0	1,540	0	4.4	30,065	17,003
K	C, F	1,500	0	4.3	0	NA	
L	N, F	0	1,000	0	2.9	NA	
M	C	0	910	0	2.6	66,622	7,661*
N	C	0	910	0	2.6	15,789	17,583
O	C	0	895	0	2.6	3,468	0
P	C, F	0	690	0	2.0	NA	
Q	C	500	670	1.4	1.9	3,927	1,155*
R	C, F	655	0	1.9	0	NA	
S	N	630	0	1.8	0	NA	
T	C, F	580	0	1.7	0	NA	
U	C	0	545	0	1.6	1,925	1,395

* Have approval to hedge anticipatory processing requirements under §1.3(z)(2)(ii)(C).

1/ Type indicators are: C - Commercial; N - Noncommercial; F - Foreign.

2/ Cash positions are as of July 7, 1989; NA - no cash reports required.

Cash Soybeans - No 1 Central Illinois



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SOYBEAN CASH PRICE CHANGES DURING JULY 1989
(CENTS PER BUSHEL)

MARKET	JULY 5-11	JULY 12	JULY 12-20	JULY 20-AUG 2
Decatur, Ill.	-58	-38	+20 3/4	-75 3/4
Des Moines, Ia.	-51	-35	+ 7 3/4	-85 3/4
Decatur, Ind.	-40	-39 1/2	+25 3/4	-90 3/4
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Upper Ill.River	-53	-32	+25 1/4	-79

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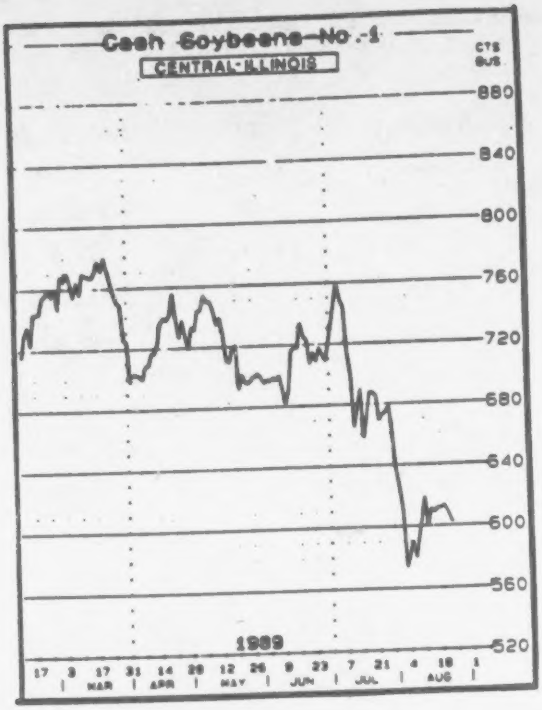

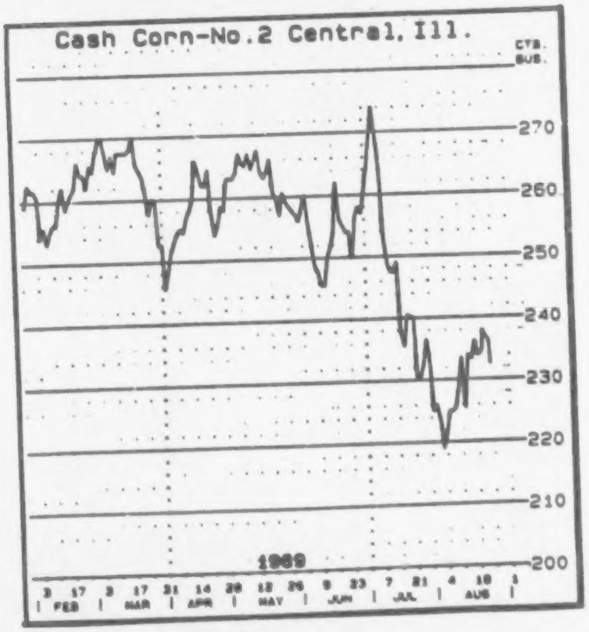

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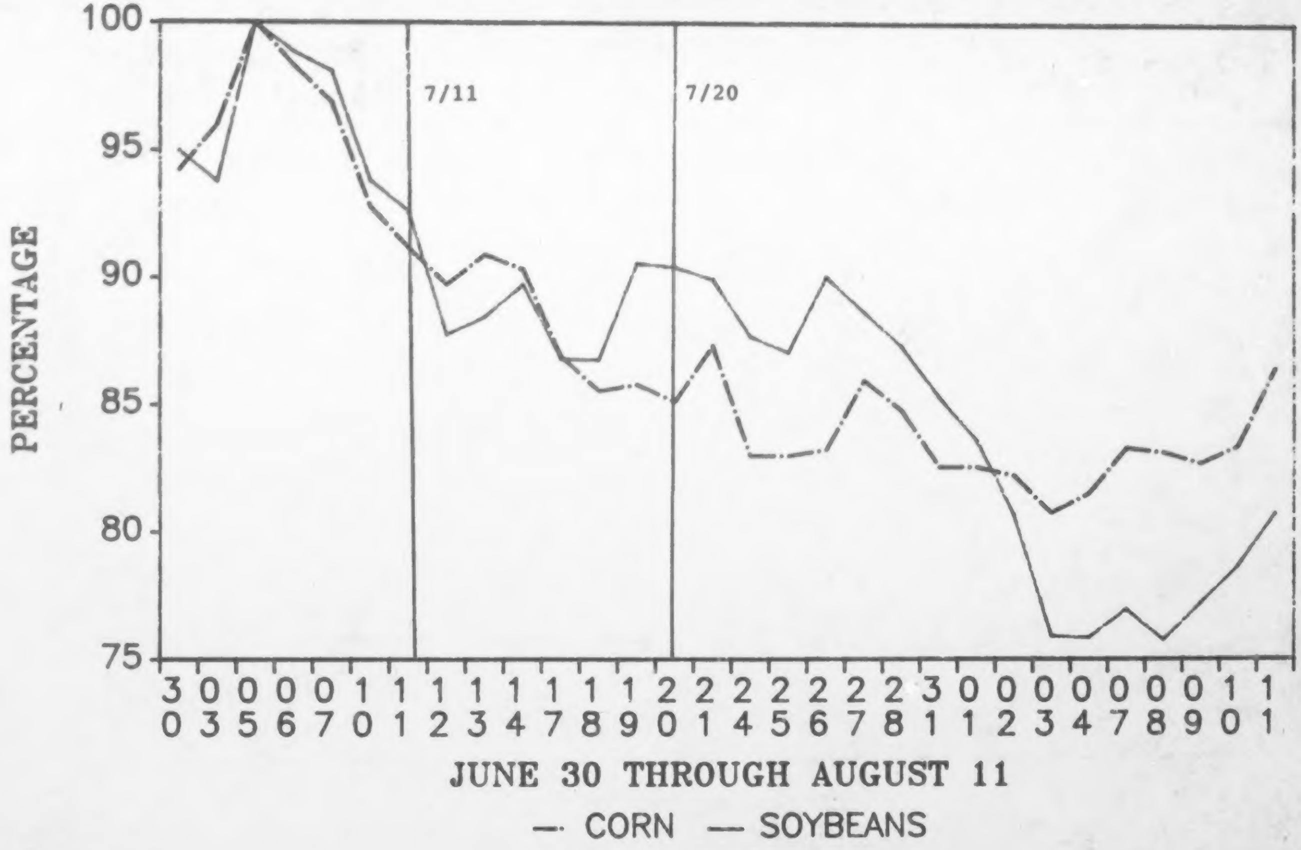
DECATUR,IL. CORN AND SOYBEAN CASH PRICES

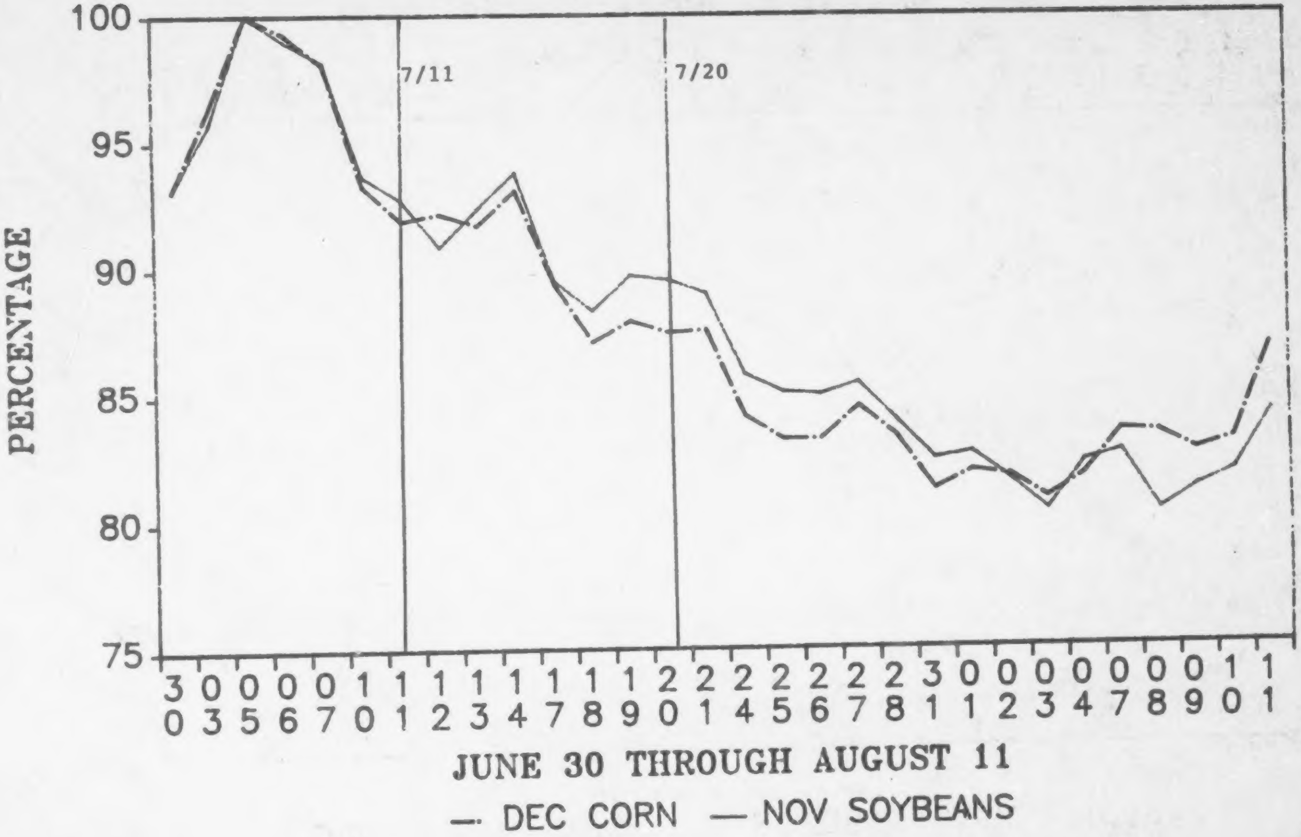
AS A % OF THE JULY 5 PRICE



JULY 5 = 100

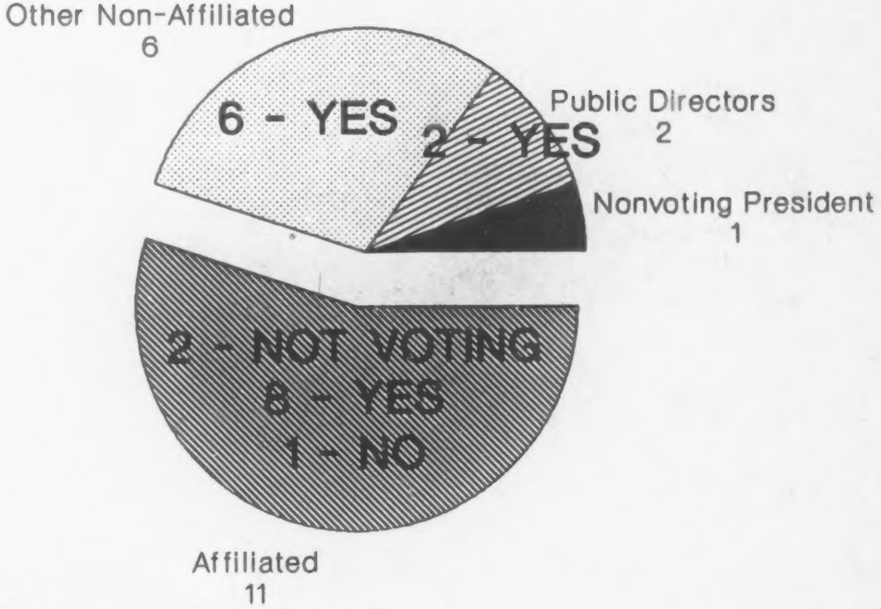
CBT CORN AND SOYBEAN FUTURES PRICES

AS A % OF THE JULY 5 PRICE



JULY 5 = 100

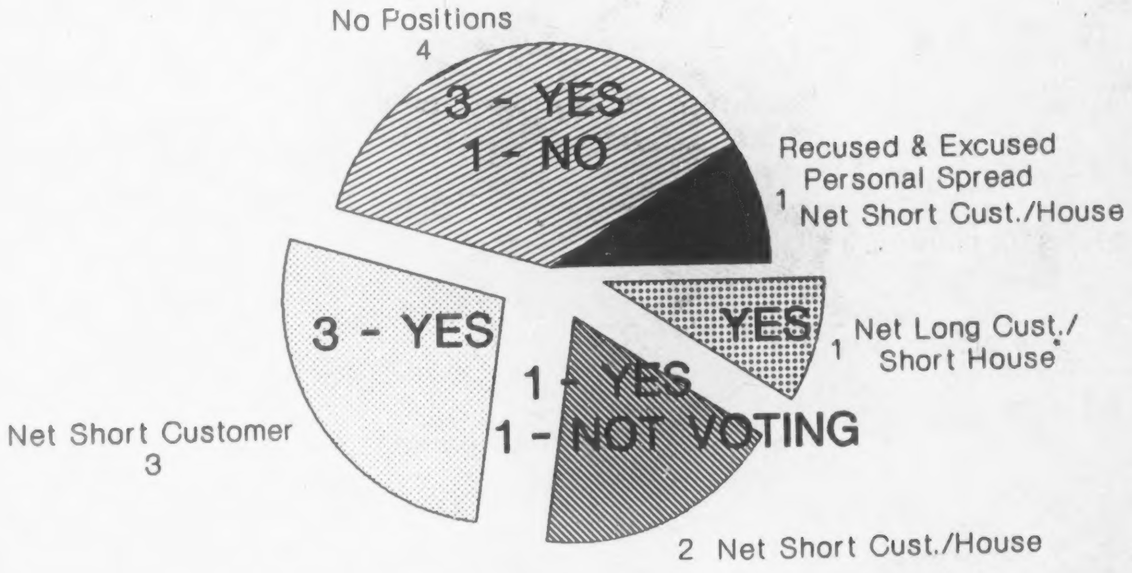
Composition of CBOT Board (Soybean Liquidation Vote)



Affiliated: Officer/Partner of Registered Firm

Positions of Affiliated Members

(Soybean Liquidation Vote)



Affiliated: Officer/Partner of Registered Firm

* - combined position net long

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Kalo A. Hineman
Commissioner

(202) 254-6318

October 5, 1989

The Honorable Patrick J. Leahy
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510-6000

Dear Chairman Leahy:

During my testimony before the Senate Committee on Agriculture, Nutrition and Forestry on September 8, 1989, Senator Harkin asked (transcript, p. 129) about the extent of complaints to the Chicago Board of Trade concerning the soybean futures market prior to liquidation of the July 1989 contract.

Our Director of Surveillance, John Mielke, raised this question with the management of the Chicago Board of Trade and received copies of five letters dated between July 6, 1988 and June 30, 1989. I have enclosed copies of those letters as well as the CBT cover letter to Mr. Mielke, which refers to an additional oral complaint which was not followed up in writing.

As you know, Section 8 of the Commodity Exchange Act generally precludes the Commission from disclosing publicly certain market sensitive and other information in its possession. However, to provide as complete a response to Senator Harkin's question as possible, the Commission has exercised its discretion under Section 8(b) of the Act to provide this information to you in connection with the Committee's proceeding.

I trust this responds satisfactorily to Senator Harkin's questions.

Sincerely,

Kalo

Kalo A. Hineman
Commissioner

cc: Senator Tom Harkin

Chicago Board of Trade

Frederick J. Grede
Vice President
Administration & Planning

September 26, 1989

RECEIVED
SEP [illegible]

Mr. John Mielke, Associate Director
Division of Economic Analysis
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear John:

The Board of Trade has searched its files for any complaints or letters of inquiry regarding the soybean market at the Exchange. Attached are five letters in that regard. The date on the Cargill letter of July 6, 1988, is correct. We also received an oral complaint from Mr. Archie Gwathmay of Bunge expressing concern about the July soybean contract. However, no follow up letter was ever received.

If you need additional information, please contact me.

Sincerely,

Frederick J. Grede

Frederick J. Grede

Attachments

LaSalle at Jackson
Chicago, Illinois 60604
312 435-3606

JUN 30 1989

CONTINENTAL GRAIN COMPANY
North American Grain Division
222 South Riverside Plaza, Suite 2800
Chicago, Illinois 60606

(312) 207-5100

June 30, 1989

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board of Trade
141 W. Jackson Boulevard
Chicago, IL 60604

VIA MESSENGER

Dear Mr. Mahlmann:

For many years, Continental Grain Company has utilized the Chicago Board of Trade futures markets as a hedging medium to reduce some of the risk inherent in the trading of agricultural commodities. Essentially, we use the futures markets to reduce risk by exchanging "basis" risk for "flat price" risk. By and large, this activity has been an effective and successful tool.

Unfortunately, at the present time, a situation has developed that makes hedging old crop soybeans more speculative than not hedging at all. The volatility and lack of liquidity in the July soybean futures contract has caused us to significantly curtail those cash programs that would normally utilize this contract. Your statisticians and my traders can both tell you that the correlation of price changes of the July futures contract with price changes in the cash markets has deteriorated significantly over the past 30-45 days. This same situation occurred a year ago and, if it continues, will threaten the viability of the soybean futures market.

A disturbing common thread in both years has been and remains the control of a very dominant position in delivery stocks by one entity and the failure of that player to rationally respond to the economic realities generally accepted as underpinning our markets. Barges are being loaded out of delivery markets while clearly cheaper alternative sources of supply not only exist but also are readily substitutable for those same delivery stocks. ... Why? ... More deliveries were demanded by this long against the May contract who, with hindsight, was not able to execute all of his previously-held ownership prior to the July contract coming current. ... Why? ...

Mr. Karsten Mahlmann
June 30, 1989
Page two

There are only two conclusions that can be drawn from what is happening. First, this player is dealing with a different set of economic realities as contrasted with ourselves and others. Second, market manipulation is being attempted.

It is imperative that the Board of Trade, through the appropriate channels, determine which of these two situations exists while there still remains some shred of confidence in our markets.

Sincerely,

Paul L Krug

Paul L. Krug, Jr.
Vice President & Trading Manager
North American Grain Division

PLK:cdd

cc: P. Fribourg
J. Laesch
J. Zick

TENCO Limited Partnership
141 W. Jackson Blvd.
Suite 1720
Chicago, Illinois 60604
(312) 786-2929

June 28, 1989

Mr. Wallace G. Weisenborn
Chairman
Business Conduct Committee
Chicago Board of Trade
141 W. Jackson, Blvd.
Chicago, IL 60604

Dear Mr. Weisenborn:

Imagine the following scenario. A participant in a futures market owns all of the physical supply in the delivery locations. That same participant sells the physical supply at a large discount to delivery value which reduces the supply available for delivery. That same participant concurrently holds a large long in the spot futures contract. As the price of the spot future remains a premium to the value of the physical, deliveries are made to the long holder. A small portion of the long is satisfied by the delivery mechanism and the remainder of the long futures position is liquidated by the short buying back the future (from the long) at a substantial premium to the value of the underlying physical.

If the process outlined above sounds familiar, it should. It describes the activities of a participant in the Chicago Board of Trade soybean contract. The result of a long holder continuing to pursue this course would (in my opinion) be the following:

A) the destruction of the integrity of the contract as deliveries would have no effect on the price determining function.
B) the demoralization of the soybean contract as a direct result of (A)
C) price manipulation (by means of a corner) of the expiring contract.
D) the undermining of the entire futures contract marketplace as a result of A, B, C (acts detrimental to the Chicago Board of Trade).

The Business Conduct Committee has the authority to investigate and if necessary punish any member or member firm guilty of A, B, C or D. Apparently the Business Conduct Committee did not investigate; or if so, did not find any evidence of A, B, C or D during the May 1989 expiration or in any act (including the sale of soybean warehouse receipts) on behalf of the long holder following the last trading day of May '89 soybean futures through present. There is ample clear evidence which would prove that the long holder has accomplished A, B, C and D.

As a direct result of the above, the commercial viability of the CBT soybean contract is under constant attack. Suggestions such as huge increases in spot month margin, narrowing the Toledo discount and adding additional delivery locations have been made with the idea that they would cure the ills and muffle the complaints. These changes would only harm the contract, not correct the problem.

The Business Conduct Committee has the responsibility to maintain a fair and orderly market. An orderly and unfair market is not a healthy situation.

Sincerely,

Thomas E. Neal

cc: Donovan
Downs
Early
Goldenberg
Mahlmann
Rutz

TENCO Limited Partnership
141 W. Jackson Blvd.
Suite 1720
Chicago, Illinois 60604
(312) 786-2929

June 30, 1989

Mr. Wallace Weisenborn
Chairman
Business Conduct Committee
c/o Market Surveillance
Chicago Board of Trade
141 W. Jackson Blvd., 'B' Level
Chicago, IL 60604

Dear Mr. Weisenborn:

The Soybean Committee met Tuesday, June 27. At this meeting the committee members voiced a unanimous opinion that there was a "problem" with the soybean contract and that BCC was not doing an adequate job in monitoring it. I was the most critical of BCC's actions to date. I don't know everything that your committee has tried, or is trying to do in this regard, but what I see and hear leads me to conclude that the attempts to date are woefully inadequate. It is my belief that this troublesome situation could only be laid to rest by conducting an exhaustive review. This means trailing the trades in soybean futures that become warehouse receipts (WHR) and continuing the trail through the point of change of beneficial ownership in the cash market. These futures / WHR transactions must then be evaluated by reviewing the economic merit of each transaction determined by the daily values, events etc. in the cash soybean market. I realize, in order to accomplish these steps, your committee would have to invest an incredible amount of time to locate and assemble all of the data and then be able to decipher the data. I believe this to be the only way to stop the abuse of the soybean contract without concurrently hurting all other participants as would increasing spot margins, trading for liquidation only, adding additional delivery locations or reducing the Toledo discount. I strongly urge your committee to begin this type of investigation with a data review start date of May 1, 1989.

Sincerely,

Thomas E. Neal

cc: Donovan
Downs
Early
Mahlmann

CARGILL

1060 La Salle Bank Bldg.
135 South La Salle Street
Chicago, Illinois 60603

May 15, 1989

Business Conduct Committee
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, Illinois 60604

RE: May 1989 Soybean Futures Contract

Dear Committee:

We appreciate the opportunity to appear before the Business Conduct Committee today to discuss one of the most significant problems to face the Exchange in many years. Cargill has been concerned by situations developing in the soybean futures contracts for over a year. We have expressed our concerns in a letter to Yvonne Downs dated April 28, 1988, in a letter to Karsten Mahlmann dated May 27, 1988, and in numerous committee meetings over the past months. We have expressed concern whether the nearby soybean futures contracts have been performing properly as effective hedging tools. This situation has been particuarly difficult for out of position hedgers. The situation in the May soybean contract should come as no surprise to anyone who has been following the soybean contracts over the past year, particularly in light of the way stopped bean receipts have been held off the market.

You requested information concerning our position in the May 1989 soybean contract. The short futures position is a hedge against ownership of cash beans substantially in excess of our combined futures position.

Please refer to the attached sheets describing the economics for beans out of Chicago and Toledo. Based on today's economics and the 15¢ May/July inverse, cash beans are trading at a 9 to 16¢ per bushel discount to delivery equivalent as of the day beans are stopped. The cost of taking delivery increases approximately 4¢ per bushel (interest and storage charges) for every ten days the beans are held in Chicago. In addition, the inverted cash market increases the cost further.

Just last week, Cargill sold a cargo of Number 2 lake beans at 4¢ over July FOB Duluth. Considering the freight spread, this price equates to 8¢ over July FOB Chicago which equalled 7¢ under May FOB Chicago (based on the 15¢ May/July spread). The cost of loading out stopped beans is approximately 8¢ per bushel reflecting the cost of weights and grades, stevedoring and elevation. Therefore, the referenced sale translates to a discount of

May 15, 1989
Page Two

approximately 15¢/bushel to taking delivery of May beans. Cargill continues to offer beans out of the lakes at similar prices.

Cargill's soybean processing operations have been seriously affected by the futures market conditions described above. We believe that our margins have been negatively impacted by approximately 20¢ per bushel. We are seriously reconsidering our operating philosophy because of the difficulty we face in using futures as a hedge against inventories. In some locations, we may reduce our bean inventories to a minimum so that we can decrease our short futures exposure.

We realize the inherent difficulty faced by the Exchange in comparing cash markets to futures prices; however, the current economics are so out of line that the futures price appears to us to be artificial. If we are correct in our fear that one party controls virtually the entire visible supply and is also long futures, we believe that the market is being manipulated.

Sincerely,

CARGILL, INCORPORATED

By ______________
FRANK L. SIMS

SOYBEAN ECONOMICS

	CHICAGO		TOLEDO/MAUMEE	
	2 YSB	3 YSB (FM Only)	2 YSB	3 YSB
Instore	Opt. Px	-4	-8	-12
Out Elevation	+6	+6	+6	+6
Wts/Grades	+1	+1	+1	+1
Upgrade to 1 YSB (Ave. Load 1.8 FM)	+6-1/4	+14 (Ave. Load 2.8 FM)	+6-1/4	+14
Rail FOB Equiv.	+13-1/4	+17	+5-1/4	+9
Stevedoring	+1-1/4	+1-1/4	+1-1/4	+1-1/4
FOB Water	+14-1/2	+18-1/4	+6-1/2	+10-1/4

COST TO CARRY

1 day 7.50 bus 10% Int. = .00205 day
1 day Storage = .00160 day
1 day Total = .00365 day
10 days = .037
15 days = .548
20 days = .073
30 days = .11

BARGE FREIGHT

		CIF EQUIV (1 YSB)	K/N Inverse		MARKET MAY :
117-1/2%	.2037 bu.	K+34-3/4	+15	= +49-3/4N CIF	31+N bid 33+N ask
120%	.2080	K+35-1/4	+15	= +50-1/4N CIF	
122-1/2%	.2124	K+35-3/4	+15	= +50-3/4N CIF	
125%	.2168	K+36-1/4	+15	= +51-1/4N CIF	
130%	.2254	K+37	+15	= +52N CIF	
140%	.2428	K+38-3/4	+15	= +53-3/4N CIF	

LAKER FREIGHT	CHICAGO	TOLEDO
2 YSB Delivery Instore	K PX	K-8
FOB to FOB St.Lawrence	-28 per bu.	26-1/2
Elevation	+6	
Wgh/Insp	+1	

2YSB FOB St.Lawrence	+35K	
K/N Inverse	+15	

	N+50	

Frt Advantage Lawrence vs. Gulf -3-3/4 (1.00 ton)

FOB Gulf offers today N+33 to 34 vs. Delivery Economics
, Equalling +46-1/4N

CARGILL

[illegible] La Salle Bank Bldg.
[illegible] South La Salle Street
Chicago, Illinois [illegible]

Rec'd 07/8/88

July 6, 1988

Ms. Yvonne J. Downs
Vice President and Administrator
Office of Investigations and Audits
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, Illinois 60604

Dear Ms. Downs:

We have and will continue to evaluate the economic justification for our positions. Today, we feel there is absolutely no justification for being long July beans.

We have purchased beans into Chicago at 15 to 23 cents per bushel under the July and export premiums are trading well below delivery economics.

We feel it is imperative for the future of this exchange to enforce policies that insure that cash and future markets come together, and fully support your efforts in policing this critical function.

Sincerely yours,

Joseph M. Hausback
Assistant Vice President
Cargill, Incorporated

JMH/db

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Kalo A. Hineman
Commissioner

(202) 254-6318

October 16, 1989

The Honorable Patrick J. Leahy
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510-6000

Dear Chairman Leahy:

On October 5, 1989, in response to a question raised by Senator Harkin during my September 8 testimony before the Committee, I provided you with copies of a number of complaint letters the Chicago Board of Trade received prior to liquidation of the July 1989 soybean futures contract. We subsequently learned of several additional letters that had not turned up in the CBT's review of its files. In order to provide the fullest possible response to Senator Harkin's question, I have enclosed copies of those letters, along with the cover letter which accompanied them.

Sincerely,

Kalo A. Hineman
Kalo A. Hineman
Commissioner

cc: Senator Tom Harkin

CARGILL, INCORPORATED
LAW DEPARTMENT
P.O. BOX 9300
MINNEAPOLIS, MN 55440
TELEX 290625
TELECOPIER (612) 475-6049

John F. McGrory
Senior Vice President
Secretary &
General Counsel

James D. Moe
Vice President
Assistant Secretary &
Assistant General Counsel

Ronald L. Laumbach
Vice President &
Assistant General Counsel

Linda L. Cutler
Assistant General Counsel

Gretchen O. Benin
Shirley R. Boyd
Frederick L. Budde
Steven Euller
Henry W. Gjersdal, Jr.
Patrice H. Halbach
H. Jed Hepworth
Grace Murga Musiek
Bonnie E. Requist
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Karen L. Bast
Sheila A. Brennan
Todd T. Erickson
Ronald E. Hunter
David L. Jacobson
Joseph R. Liesch
Laura W. Miller
Barbara A. Olson
LaFaye M. Osborne
Christopher M. Stang
James E. Van Valkenburg
Laura Hiebert-Wise

Writer's Direct Dial Number

(612) 475-6377

October 6, 1989

VIA COURIER

John Mielke
Division of Enforcement
Commodity Futures Trading Commission
Washington, D.C. 20581

Re: CBOT Soybean Futures

Dear Mr. Mielke:

Pursuant to our telephone conversation I am enclosing copies of additional correspondence between Cargill and the CBOT as follows:

1. Letter from Peter von Eshen to Yvonne Downs dated April 28, 1988;
2. Letter from Peter Kooi to Karsten Mahlmann dated May 27, 1988 with attachment dated May 25, 1988;
3. Letter from Frank Sims to Wallace Weisenborn dated May 9, 1989;
4. Letter from Frank Sims to Business Conduct Committee dated May 16, 1989;
5. Letter from Peter Kooi to Karsten Mahlmann dated May 18, 1989.

These letters, together with the two letters you already have (July 6, 1988 and May 15, 1989), constitute all the correspondence from Cargill to the CBOT that might be considered responsive to the inquiry.

Yours truly,

Linda Cutler

Linda L. Cutler

LLC:jh
Enclosure(s)
cil/3270

OCT 05 88 10:04 P02

CARGILL

[illegible] La Salle Bank Bldg.
[illegible] South La Salle Street
Chicago, Illinois [illegible]

April 28, 1988

Ms. Yvonne Downs
Vice President and Administrator
Office of Investigations and Audits
Chicago Board of Trade
141 West Jackson
Chicago, Illinois 60604

Dear Ms. Downs:

For some months, a significant portion of the delivery stocks of soybeans has apparently been isolated from the delivery market. This effectively reduced the deliverable supplies when neither the cash market nor the spread relationship seemed to so dictate. The result was that spreads were probably not permitted to seek economic levels making it more difficult for the hedger, especially those that were out of position, to use the futures markets.

Since the proper functioning of the futures market is so dependent upon the delivery process which in turn looks to the economic utilization of delivery stocks, we hope you are carefully monitoring the situation.

We will be happy to supply you with additional information should you so desire.

Sincerely,

Peter A. von Eschen

Peter A. von Eschen
Assistant Vice President

PVE:mad

CARGILL

Box [illegible]
Minneapolis, MN [illegible]

Peter A. Kooi
President
Commodity Marketing Division

May 27, 1988

Mr. Karsten Mahlmann, Chairman
Chicago Board of Trade
LaSalle at Jackson
Chicago, IL 60604

Dear Cash:

Per our phone conversation, there is growing concern by "out of position" hedgers regarding futures spreads. As a member of the Executive Committee of the NGFA, I have asked our Commodity Exchange Committee to review the situation, and the potential alternatives. Ideally, the National would work closely with the committee system of the CBOT on this important item.

Thanks again for your attention and support.

Regards,

Peter A. Kooi

PAK:kmd

Attachment

cc: Kendall Keith

CARGILL

Box 9300
Minneapolis, MN 55440

Peter A. Kooi
President,
Commodity Marketing Division

May 25, 1988

Mr. Don McElmury, Chairman
Commodity Exchange Committee
National Grain & Feed Association
725 15th St. N.W.
Washington ,D.C. 20005

Dear Don:

Beyond their role in price discovery, the CBOT futures contracts provide an equally important function to the grain industry in the price insurance or hedge category. Historically, in times of surplus the hedging process allows cash longs to hedge their ownership and earn carrying charges on the grain they carry in their space. This situation usually exists at harvest or at other times of the year when cash premiums are weak (below delivery values.)

Theory has been that if there is sufficient total space in the primary delivery markets, Chicago and Toledo, and adequate supplies, that "out of position" hedgers will be protected in the delivery process. This has been debated over the years, with some still strongly of the opinion that more delivery points are needed to protect the short hedger in times of more than adequate supplies.

There is a growing concern in the marketplace that current theory isn't working, that carrying charges are not reflecting reality. The importance of this is heightened as the marketplace moves from government storage to inventory accumulation. This has been a problem for all grains for some time.

Specifically, today soybean carrying charges seem especially narrow given premiums at 15/20¢ discounts to delivery values, large cash inventories held by elevators and crushers, and large stox in the delivery market. As the wheat crop is harvested and we get closer to the harvest of corn and beans, this kind of situation could well be repeated.

Mr. Don McElmury
May 23, 1988
Page 2

In that regard, I think it is important that your committee look into this matter, and look at the alternatives. Those could include discussions with the CBOT, CFTC, etc. re

- current delivery space
- additional space/markets such as Huron/Milwaukee/Duluth
- Toledo delivery differentials
- multiple delivery points in the interior
- better policing of existing contracts and market economics.
- primary vs. alternate delivery points
- effect of new limits on the delivery process

This is a critical issue for the grain industry today. Thanks for your attention.

Sincerely,

Pete Kooi

PAK/pab

cc: Kendall Keith
Brent Beglein
Jack Felts
Sam Irman
John Zick
Russ Bragg

CARGILL

1600 La Salle Bank Bldg.,
135 South La Salle Street
Chicago, Illinois 60603

May 9,1989

Wallace O. Weisenborn, Chairman
Business Conduct Committee
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, Illinois 60604

Subject: Expiration of the May 1989 Soybean Contract

Dear Wallace:

We were pleased to hear from Harold Hill (Market Surveillance) on behalf of the Business Conduct Committee. As you know, Cargill Senior Management has been concerned about economic justification in expiring contracts for some time. Specifically, in response to this inquiry this morning regarding May beans. We are very much concerned with the uneconomic manner in which the May contract has traded relative to the July and relative to Cash economics.

Cash values are a minimum of 12 - 13¢ per bushel discount to Chicago delivery equivalent and approximately 11 - 13¢ per bushel discount to Toledo delivery equivalent. At the same time, we have 21.8 million bushels (14.1 million Chicago / 7.7 million Toledo) of beans in the Visible and a total supply of free beans in the U.S. of approximately 450 million bushels.

We understand that cash beans are offered today out of the Lakes at the equivalent of 2 under the July F.O.B. as 3 YSB, while delivery equivalent out of Toledo figures 9 over the July F.O.B. and out of Chicago at 17 over the July F.O.B. Delivery is clearly an 11 - 17¢ per bushel premium to cash values in the Lakes.

The May contract is not performing its function of adequately reflecting the realities of the cash market. We are concerned that this might put the entire marketplace at a disadvantage and potentially undermine the credibility of the Chicago Board of Trade.

We have the impression and it causes us great concern that a single company may control a very substantial portion of the Bean Visible and is also long May futures. We have long held the position that economic justification in expiring futures contracts was paramount. Action needs to be taken by the appropriate committee (s) now to ensure that these sort of abuses of the

May 9, 1989
Page Two

futures market are not tolerated and that those parties responsible for same are dealt with in an appropriate manner.

Very truly yours,

Frank L Sims

Frank L. Sims
Assistant Vice President
Cargill, Incorporated

FLS/db

cc: Karsten Mahlmann
Chairman of the Board
Chicago Board of Trade

Yvonne J. Downs
Vice President & Administrator
Office of Investigations and Audits

CARGILL

1000 La Salle Bank Bldg
135 South La Salle Street
Chicago, Illinois 60603

May 16, 1989

Business Conduct Committee
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, Illinois 60604

RE: May 1989 Soybean

Dear Committee:

In reference to your letter dated May 16, 1989 regarding Cargill's position in May 1989 soybeans:

- As of the close of business May 16, 1989, our position in May soybeans [redacted]
- Our plans currently are to [redacted]
- May soybean futures are such a premium to cash that more beans would move into Chicago if time and logistics permitted. As I mentioned in my appearance before the Committee on Monday May 15, 1989, it is virtually impossible for any warehouseman to anticipate such an uneconomic and artificial move in May beans. It takes time to originate, transport, unload and receipt grain for the delivery process. The marketplace simply did not anticipate this situation as evidenced by the size of the out of position hedges and especially in light of the cash economics.

We are amazed that the regulatory authorities have permitted a single firm to amass such control of the soybean visible as well as a dominant position in the expiring futures contract at a time when the cash economics in soybeans are so compelling against such a position.

I trust this letter adequately addresses the points raised in your letter and if we can be of any further assistance, please advise.

Regards,

CARGILL, INCORPORATED

BY:

Frank L. Sims

FLS/db

cc: David A. Kass
Director-Market Surveillance

CARGILL

Box 9300
Minneapolis, MN 55440

Peter A. Kooi
President,
Commodity Marketing Division

CONFIDENTIAL

May 18, 1989

Mr. Karsten Mahlmann
Chairman
Chicago Board of Trade
LaSalle at Jackson
Chicago, IL 60604

Dear Cash:

Pursuant to our conversation this morning, Cargill [redacted] bushels of May bean futures. We did so in an orderly fashion, throughout the session. We will do a similar job tomorrow.

We do want you to know that we did this at your strong request. We believe the prices that we paid were artificial, and far above today's cash market equivalent.

We are happy to note your deep involvement in this problem. We encourage you to continue and deepen your investigation into the economics surrounding May beans.

As you know, we have been very concerned about the functioning of the futures markets for some time. Developments in the bean market over the past year have heightened that concern.

We all have a lot at stake in assuring an economic marketplace. We are happy to lend any assistance you might require in this endeavor.

Sincerely,

Peter A. Kooi

PAK:kmd

cc: Wallace G. Weisenborn, Chairman, Business Conduct Committee, CBOT
Scott E. Early, General Counsel, CBOT
Linda Cutler, Cargill Incorporated
Dan Huber, Cargill Incorporated

bcc: Jim Howard/Joe Hausback/Chad Burlet